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LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING

It's the Debt, Stupid

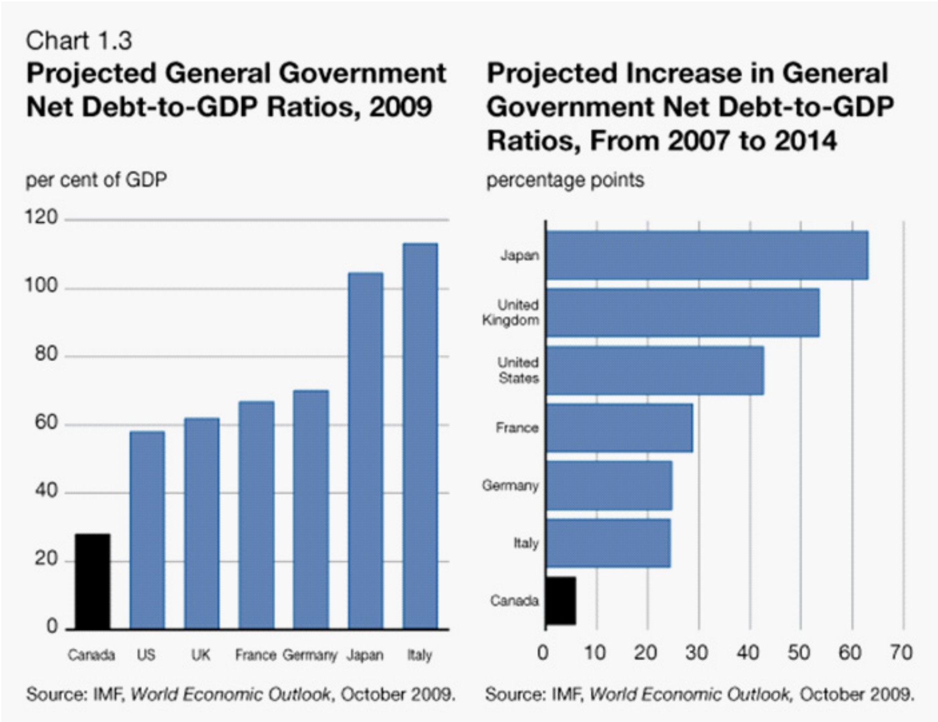
"When President Clinton was fighting his first presidential campaign against George H.W. Bush, he kept a piece of paper in his pocket on which he had written,' it's the economy, stupid.' This was to remind him that that he was fighting the election during a time of a mild recession in the US. In like manner, all my readers need to know is that, 'it's the DEBT, stupid,' which is the principal cause of the impending depression." The Long Wave Analyst, January 2003. P. 4

Never in the history of mankind has there been a global debt bubble of the current magnitude. This has all been enabled by a fiat monetary system, which has been grossly mismanaged through the exorbitant use of the printing press. Nowhere has this been better demonstrated than in the United States, which had a moral responsibility to temper her fondness for debt, because of the extraordinary privilege accorded to the U.S. dollar as the world's reserve currency.

This monstrous debt bubble has now exploded and effectively, many countries, their corporations and their citizens are now bankrupt. There is a masquerade of solvency which is currently being showcased, but how long this charade can be maintained is anyone's guess. My guess is not for long and by that I mean months, rather than years.

We must remind ourselves that while massive debt bubbles have occurred several times throughout history, this time it is much bigger and more international in scope, than any of its predecessors. The miserable outcome, when the debt bubble bursts, has always been a deflationary depression. With the bursting of the current debt bubble, there is no chance that a deflationary depression can be avoided. "It is a delusion to think that a depression caused by credit can be resisted. All the panaceas, nostrums, and quacks invented by all the politicians in the world, can but hold off the eventual day of reckoning, prolonging the agony." Smitley, Robert. Popular Financial Delusions, Fraser Publishing Company, Vermont, 1984; first published in 1933. P. 9

Austria's recent bank nationalization of Hypo Group Alpe Adria, reportedly fearing its collapse, might spark a "Lehman Bros. effect" in emerging Eastern Europe. This is a reminder of the collapse of Austria's leading bank Credit Anstalt of Vienna in May, 1931, which ultimately caused Austria to abandon the gold standard. Then, Great Britain followed suit in September of that same year, leading to the eventual collapse of the world's monetary system. In a similar vein 79 years later, financially strong euro zone countries, such as Germany, are being forced to come to the aid of 'weak sister' euro zone economies, where the public debt far exceeds the 60% limit set by the Maastricht Treaty, not only, raising concerns regarding the effectiveness of the European Union legislation, but also, the very survival of the EU itself. In a worst case scenario, countries that default on their debt will endure a prolonged period of high interest rates, capital constraints and significant contractions of their gross domestic product (GDP). Indeed, we believe that current projections for GDP growth of the world's most developed economies over the next several years, will prove wildly optimistic.



Beware of Greeks Bearing Gifts

Greece is in the throes of the most serious fiscal emergency to strike the euro zone since the single currency's launch in 1999. Following another recent review and not unexpectedly, Standard and Poors and Fitch Ratings cut Greece's sovereign debt credit rating to BBB (High) from A (Low). Under George Papandreou's socialist government, Greece's budget deficit has grown to nearly 13% of its gross domestic product. With a decidedly poor economic outlook and continuing wage inflation pressures, Greece's deficit is clearly destined to increase further. Indeed, Greek Government 2-year bond yields have recently risen by 130 basis points (or by 1.3%), while the yield spread between Germany's 10-year bonds and Greece's 10-year issues has widened to 250 basis points (or 2.5%). Huw Worthington, fixed income strategist at Barclay's capital commented: "Greece is now clearly the worst performing economy, but other countries must show they can deal with their debt problems, or there could be a selloff in their (bond) markets also. Investors want debt levels reduced, now!"

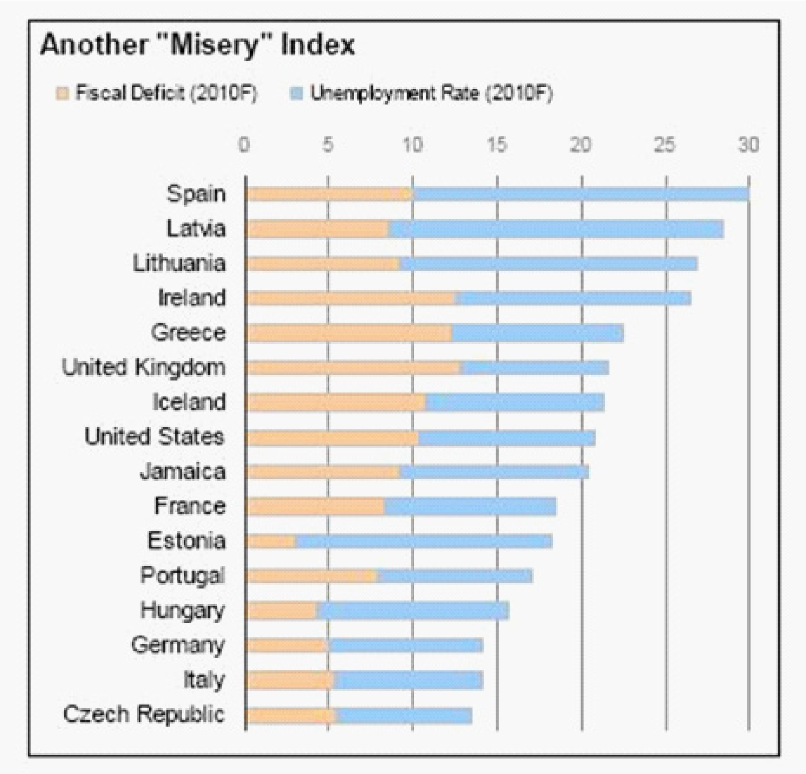
In short, Greece has become the pariah of the euro zone for investors, since all the key economic statistics point to an economy that is close to implosion. Its debt to gross domestic product will become the highest in the euro zone next year at 123%. Hastily arranged visits by Greek Finance Minister George Papaconstantinou to Berlin, Paris, London and Frankfurt, in an attempt to reassure governments and markets have fallen on deaf ears. In an Athens speech, Mr. Papandreou warned that "Greece has lost every trace of international credibility and is in danger of drowning in debt." The Prime Minister called for unity, saying that in the next three months, his government would take decisions that have not been taken for decades. Tired of empty rhetoric and pledges, he added, the bond market wants to see concrete government action.

Pointedly, while Finance Minister Papaconstantinou plans to borrow at least 54 billion euros ($77 billion U.S.) in 2010, compared with 66 billion euros in 2009, he has admitted to the inherent risks involved if the government is unable to restructure the country's finances along more responsible lines. "There is a scenario in which the market dries up for Greek bonds and I wouldn't say it's completely out of the question; but I don't want to be the finance minister who took Greece to the International Monetary Fund (IMF)." European Union authorities harbour a preference to deal with any financial assistance on an internal basis. Moreover, Jean-Claude Trichet, European Central Bank President, has recently commented that Athens will have to act "courageously" to bring its budget (deficit) under control. In recent years, Greece's economic growth was highly dependent upon a construction bubble, albeit plagued by runaway income tax evasion. While the EU governments, the credit rating agencies and the fixed income markets continue to pressure Greece to make deep public spending cuts, the Greek government has proven reluctant to comply, fearing more waves of social unrest from groups of students and public sector labour unions.

Attending an EU summit in Brussels in December, Prime Minister Papandreou acknowledged to his fellow European leaders that massive bureaucratic inefficiency and "widespread corruption" are blocking investment and crippling Greece's economy. "Our basic problem is systemic corruption and we intend to take harsh measures to root it out." Other euro zone members cite the underlying problem with official Greek prose to be one of credibility. The above notwithstanding, following a five-day debate in parliament, all 160 Socialist lawmakers approved a Christmas Eve budget aimed at increasing tax revenues, while introducing a freeze in public sector hiring and 10% cuts in social security and government operating expenditures. However, Moody's has deemed the Greek government's austerity plan insufficient reduce soaring deficits.

In its most recent quarterly economic report issued in December /09, the European Commission (EC) commented that the strong reaction in financial markets to signs of Greece's fiscal laxness, highlights the priority of curbing runaway government spending. The EC called Greece "a source of serious concern." Moreover, in a recent interview with the Wall Street Journal, Ewald Nowotny, the Austrian member of the European Central Bank's governing council, commented that "One has to be very clear: the ECB has no mandate or intention to take into account the situation of a specific country, especially not with regard to public finances." In a recent Bloomberg Television interview, Willem Buiter, newly appointed chief economist for Citigroup Inc. stated "unless there are radical fiscal actions, lasting cuts in spending and tax increases of at least 7% of gross domestic product, the writing is on the wall" for Greece to become the first major country in the European Union to default on its debts since the aftermath of World War II. Could a euro zone member default and still remain in the zone?

Moody's has compiled a 1970s style 'Misery Index' which combines the fiscal deficit and the unemployment rate. The chart below shows Spain, Latvia, Lithuania, Ireland, Greece and the United Kingdom as the most troubled sovereign debtors in the world.



When Irish Eyes Aren't Smiling

As the Irish Republic posted a 0.3% increase in its gross domestic product (GDP) during the third quarter, the first sign of economic growth since early 2008, economists warn that the Irish Republic's economy remains fragile. Ben May, European economist with Capital Economics commented that "We need more evidence to say that the (economic) recovery is sustainable and we think that GDP will fall by 2% in 2010 and 0.5% in 2011." Indeed, property prices continue to fall and prospects for public spending next year look bleak. Moreover, Deirde Ryan, an economist at Goodbody Stockbrokers stated that the new (GDP) data indicated "that a better than expected performance from the external sector is masking a very weak domestic environment, where there is still further weakness to come" since gross national product (economic activity excluding foreign-owned multinationals) declined by 1.4% in the same quarter. Since multinationals such as Dell Inc., the computer group, conducts its European operations from the Irish Republic, GNP is often considered a more accurate measure of consumer activity.

Ireland's Finance Minister, Brian Lenihan, has recently announced deep spending cuts to save about 7% of public finances, public sector pay cuts up to 15% and reductions to the social welfare budget of 4%. Indeed, the government will save 900 million pounds by reducing the pay packet of every public employee. Those earning less than 27,000 pounds a year face a cut of 5%, increasing to 15% for the highest paid and the Prime Minister himself is facing a 20% salary reduction. An additional 900 million pounds will be saved from capital expenditures, while cuts to social welfare programs will save 684 million pounds in 2010. Disability payments are to be reduced by 4% and the child benefit cut by 10%. These tough measures are intended to prevent the budget deficit from widening beyond 19 billion pounds in 2010, which is equivalent to 12% of Ireland's gross domestic product. The country's deficit is already four times the level allowed by Ireland's membership in the European Union and Brussels wants Dublin to shrink it to within 3% of GDP by 2014.

In reaction to Mr. Lenihan's budget, Dublin did not erupt in riots, partly because the finance minister decided not to raise taxes, except for the introduction of a carbon tax which translates into a 4 cent increase on a liter of gasoline. Simon Tilford, chief economist of the Centre for European Reform, commented that "The budget gives a graphic indication of the challenges facing Ireland and other economies in the euro zone. Ireland had no choice but to cut (public spending) and may have to cut again to avoid a run on their debt." As a member of the euro zone Ireland cannot devalue its currency to re-establish a competitive position. Wage cuts are the correct route to follow, Mr. Tilford argues, but that measure will weaken demand and even attract the risk of deflation, which would be of no help in a highly indebted country. On the optimistic side, other forecasters point to Ireland's youthful population when compared to those of Greece or Spain. The bursting of one of Europe's most dramatic housing booms, coupled with an unemployment rate of 12.5%, have destroyed the country's former sense of national pride and success. Most assuredly, the economic hope for the Irish Republic rests on the determination of the government to succeed in its deficit cutting initiative.

Philip Lane, a professor of macroeconomics at Trinity College Dublin who oversees the widely read Irish Economy blog, cites the painful, historic steps taken by Ireland's government offer a ray of economic hope, but acknowledges reordering the Irish economy from its deep reliance on construction and property will take years. Mr. Lane points to signs of wage compression in the hard-hit service, property and government sectors, as proof that there is a recognition that recovery, distant as it may seem, must occur inside the euro zone, not outside. "It takes a crisis to learn a lesson. Could it be that by getting countries to change their behavior, you might obtain improved co-operation within the euro zone? What does not kill you, often makes you stronger."

The Pain in Spain Is Likely to Remain

Equity prices fell sharply in Madrid last month, taking a toll on the Ibex 35 index of Spanish companies, after Standard and Poors (S&P) downwardly revised its outlook for Spain's sovereign debt to 'negative' from 'stable', citing its expectation of a longer and deeper economic downturn in the country. S&P affirmed AA (High) long-term and A-1 (High) short-term sovereign debt credit ratings, but said the economic situation in Spain appears to be worse than perceived in January, when the country's long-term debt lost its AAA credit rating. In a press release, S&P credit analyst Trevor Cullinan stated that "The change in the outlook stems from our expectation of significantly lower growth in Spain's gross domestic product (GDP) and persistently high fiscal deficits relative to peers over the medium term, in the absence of more aggressive fiscal consolidation efforts and a stronger policy focus on enhancing medium growth prospects."

Spain is struggling with its worst economic downturn in decades, fueled by a collapse of the construction industry. At 19.3%, the country has the highest rate of unemployment in developed Europe, even higher than many emerging countries. Spain is facing an extended period of sub-par economic performance on an annual basis, due to high private sector indebtedness and an inflexible labour market. According to S&P, "deflationary pressures could be more persistent than in most other euro zone sovereigns, which we expect would further slow the pace of fiscal consolidation in the medium term. However, if the government announces concrete fiscal measures that we believe could credibly achieve annual primary surpluses of 2% or higher by the end of the forecast period in 2012, downward pressures on the (sovereign) ratings may abate."

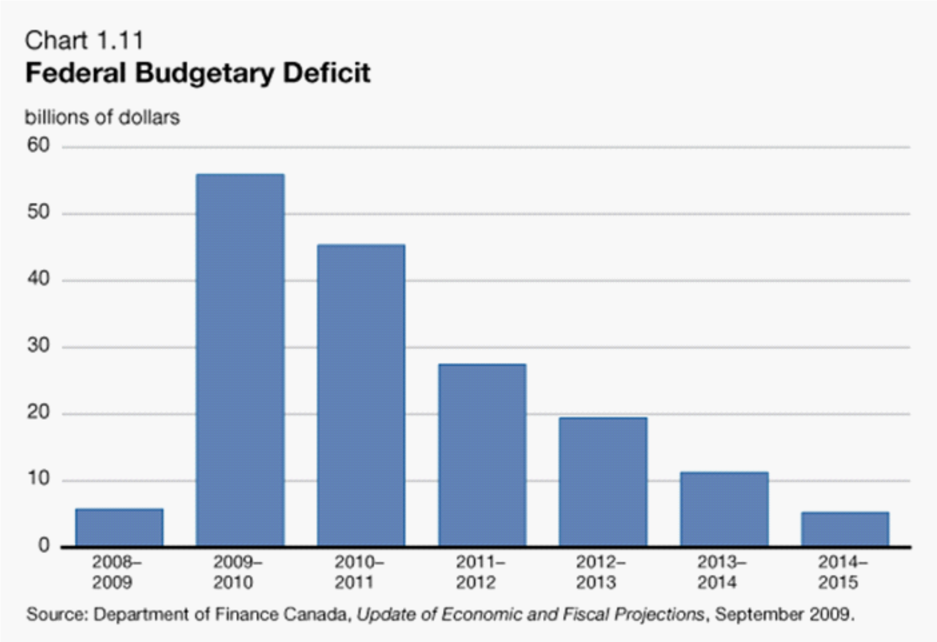
According to Labour Ministry data, fewer than half of Spain's 3.8 million unemployed are still receiving their jobless benefits which last for a maximum of two years. Unemployment among people ages 16 to 24 is 42.9%, the highest in Europe and more than double the overall rate. At this level, Spain compares rather poorly to other struggling European countries. In Greece, the youth unemployment rate is 25%, while Ireland's is 28.4% and Italy's is 26.9%. Paul Osterman, a professor at the Institute de Empresa business school in Madrid notes that "young Spanish workers also face other obstacles such as union rules, long-term contracts and legislation that protects older workers and discourages new hiring. There is a cohort of (young) people who are condemned to a permanently stagnant career path in Spain. It's very worrisome. The country is under tremendous pressure from the E.U. and the bond markets which puts it in a very difficult box. Spain is spending 30 billion euros ($43 billion U.S.) a year on unemployment benefits, but the money is doing little to prepare younger workers for the future. Unfortunately, the outlook for 2010 is rather bleak. The Spanish economy is forecast to contract by 0.8% and the unemployment rate is expected to climb still further to at least 20%.

Oh Canada, Glorious and Free

As part of its semi-annual review, the Bank of Canada is warning that stocks may be overvalued given the projected pace of Canada's gross national product, so share prices could correct if corporate results don't match expectations. It would appear that monetary officials are attempting to warn investors against becoming too bullish on equities. The review stated that "For the recent improvement in equity markets to be sustainable, future earnings must be driven by revenue growth. Equity markets may thus experience some (price) reversal if earnings growth proves to be disappointing. While indicators point in different directions, various measures, such as forward price-earnings ratios, suggest that equity prices may have increased by more than warranted, in the context of an expected slow (economic) recovery." To give credit where credit is due, Long Wave Analytics finds itself in complete agreement with the central bank on this point, at this time. Tony Demarin, president and chief investment officer of Winnipeg-based BCV Asset Management Inc. said the central bank may be trying to temper expectations by "trying to convince people to avoid getting overly aggressive again, setting up an overvalued asset class with borrowed money."

Furthermore, for the second time this month Bank of Canada Governor Mark Carney has stated that household debt is now the biggest risk to the Canadian financial system, even if it is not expected to climb to levels that could cripple bank balance sheets. The central bank uses a stress test to show that rising interest rates between mid-2010 and mid-2012 would saddle a growing number of Canadians with unmanageable debt loads. "Households need to assess their ability to service these debt obligations over their entire maturity, taking into account likely changes in both income and interest rates. Financial institutions need to carefully consider the aggregate risk to their entire portfolio of household exposures when evaluating even an insured mortgage, since a household defaulting on an insured mortgage would likely be unable to meet its other debt obligations." With inflation forecast to remain low and the Canadian economy still struggling, Mr. Carney has pledged to keep the bank rate at a record low 0.25% until mid-2010. Indeed, just two weeks ago Canada's Finance Department reported a $3.3 billion (CAD) deficit for October, 2009, citing significantly lower corporate tax receipts, but still roughly in line with its projected $56.2 billion (CAD) deficit for the fiscal year ending March 31, 2010.

Central bankers around the world will be trying to find the right timing and the right pace at which to unwind the historic monetary stimulus they undertook to fight the global economic downturn. For the present, reminding Canadians to be prudent may be the only action that Mr. Carney can undertake. Historically low mortgage rates and fiscal incentives, such as allowing first-time home buyers to use more of their registered retirement savings as a down payment, have fueled a temporary rally in the real estate sector. Strength in auto sales has also led to a further increase in consumer credit. However, raising administered interest rates sooner than the middle of this year would, not only, negatively impact the housing sector, but also, send the 'loonie' to a higher level against the 'greenback', causing more difficulties for Canada's exporters. Mr. Carney has been trying to jawbone the Canadian dollar lower since last June to little avail, so warning Canadians about the prospect of higher interest rates seems premature at the moment. Realistically, Mr. Carney finds himself between a rock and a hard place. If the economy of the United States of America contracts severely over the near to medium term as we expect, the optimistic chart below will become obsolete in no time.



The Sceptred Isle Mortgages Its Future

While Britain's real budget will not arrive until post the election likely in April, 2010, in a pre-budget report delivered last month, Chancellor of the Exchequer Alistair Darling announced that the Labour Government plans to reduce the deficit from the current 12.6% of gross domestic product (GDP) this year, to 5.5% of GDP by 2013-14. However, the Chancellor also plans to increase government spending by 1.2 billion pounds next fiscal year and accordingly, will need to borrow 178 billion pounds this fiscal year and 176 billion in fiscal 2011. Indeed, the Office for National Statistics reports a government deficit of 20.3 billion pounds ($33 billion U.S.) in November, citing the national debt as 60.2% of gross domestic product. Meanwhile, Moody's Investors Service has warned that the United Kingdom's AAA sovereign debt rating is more vulnerable than that of France and 2010 could be a "tumultuous year for sovereign issuers, wherein social and political cohesiveness would be tested."

Indeed, Marc Ostwald at Monument Securities in London states the situation plainly, "Unless the U.K. Government gets a grip soon, we're going to see the 10-year British 'gilt' yield spread over equivalent German 'bunds' widen to 120 basis points, with the risk of 150 (basis points) if there is no clear winner in a spring election." British and French 10-year maturities were trading on an even yield basis as recently as November, 2009, but when Labour's pre-budget report was unveiled in mid-December, this yield spread widened to almost

50 basis points. Moreover, 10-year 'gilt' yields are approaching Italian yield ranges, not considered great company by the fixed income market. Simon Derrick, chief currency trader at the Bank of New York Mellon cites that global markets were unimpressed by the pre-budget report and do not believe the U.K. Government forecast for 3.5% GDP growth in 2011. "The Government will have borrowed an extra 700 billion pounds by 2014, at which time the national debt will reach 1.5 trillion pounds; equal to 48,000 pounds per head of the working population. The (bond) market response is entirely rational."

The risk for gilt investors is heightened by the prospect of the Bank of England terminating its policy of quantitative easing (printing money). Under this program, the central bank has bought billions of pounds of gilts and now owns an estimated 30% of the outstanding issuance. Gilt traders and investors alike remain unconvinced that the Labour government is seriously committed to fiscal deficit and national debt reduction. If these vibes of disbelief ultimately escalate into Britain's loss of its AAA sovereign debt rating, the difficulty factor for the world's fifth largest economy to roll over its debts, will increase markedly. Since foreign investors own 217 billion pounds of U.K. debt, a significant portion of these bonds could flood the open market. Moreover, not only would government interest costs rise, but also, corporate bond yields and mortgage rates would be similarly affected. At that juncture, it would take more than a 'stiff upper lip' approach to right the ship.

Will the Lenders to Dubai Be Kissing Their Money Goodbye?

While its financial reputation has become tarnished in the eyes of international investors in recent weeks, it's probably too soon to wave goodbye to Dubai. The $26 billion (U.S.) of sovereign debt does not appear to be a problem, since it is equal to a moderate 40% of GDP and its 2009 fiscal deficit should only amount to 1.8% of GDP. According to a recent prospectus filing, the government's annual revenues of $18 billion (U.S.) are diversified as follows: 54% from visa, land and tourism fees; 19% from customs and duties; 14% from oil and gas sales and 9% from dividends paid by the Investment Corporation of Dubai, a government holding company which owns Emirates Airlines and local banking and utilities investments. However, bond investors in government-owned corporate entities, such as Dubai World, Dubai Holdings and Dubai Properties are not so well assured. While Dubai has been temporarily rescued by a $10 billion (U.S.) loan from its Emirate neighbour Abu Dhabi, it remains to be seen whether Dubai can renegotiate the terms of debt obligations of its government-owned corporations with bondholders and bankers to a more manageable basis.

In this year of 2010, it will become evident that the great experiment with paper money printing has run its course. It will be impossible for governments to continue to print money in order to paper over their debts. The debt bubble has well and truly burst and the ramifications will be horrendous. We leave you with one final quotation; "There are no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved." Ludwig von Mises. There has been no voluntary abandonment of further credit, to the contrary, credit is expanding in a misguided effort to prolong the money-printing game.

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