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LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING

The Long Wave Winter Monetary Crisis

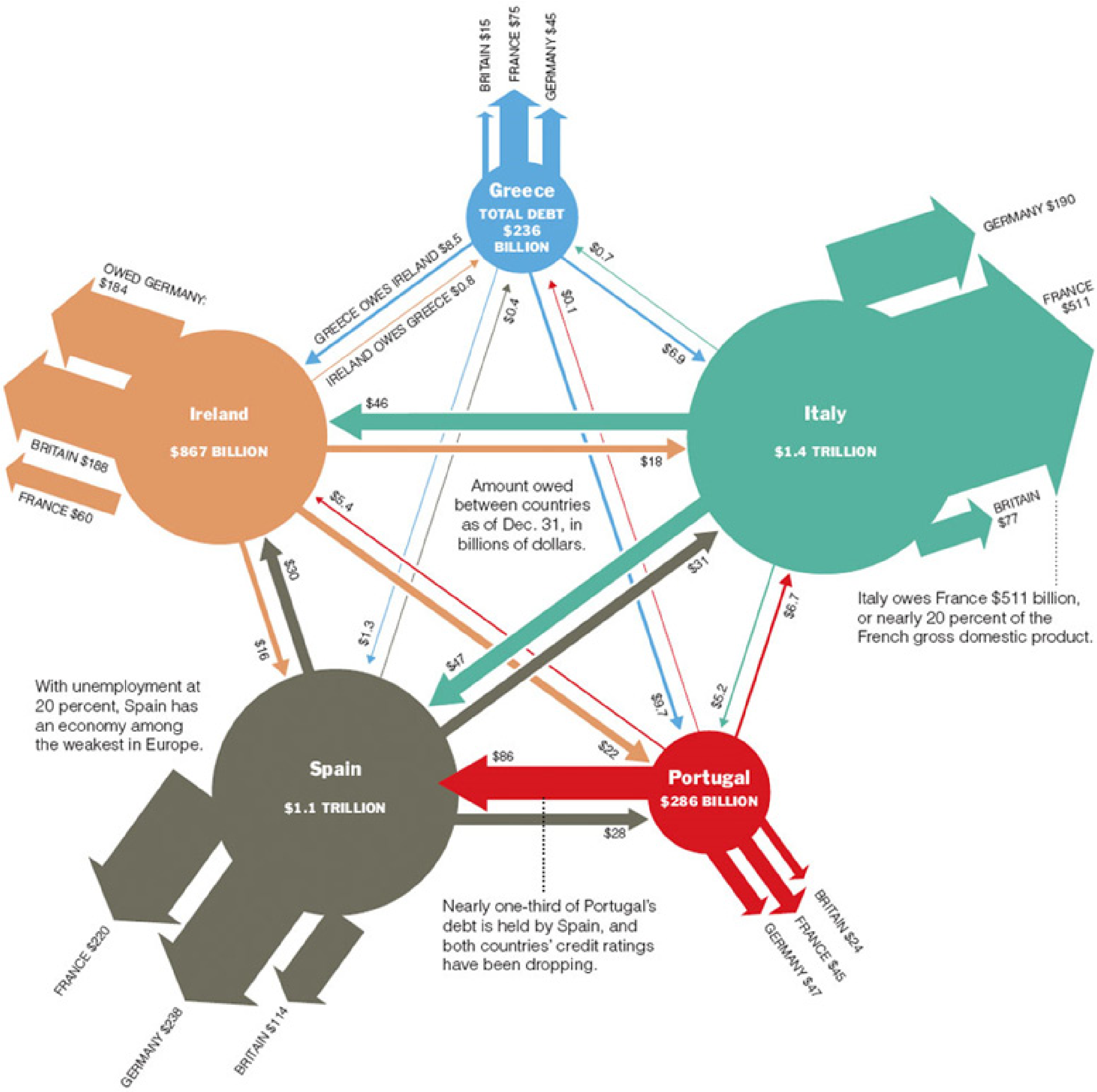
Today, as sovereign countries exacerbate their debt problems with excessive borrowing and spending programs, the global marketplace risks plunging inexorably towards a state of economic depression.

In recent months, it has primarily been the euro zone members in the Mediterranean commercial forum who have been struggling; with their fiscal deficits, soaring bond yields and sovereign debt rating downgrades.

To draw a parallel, we need only reference the Panic of 1873 which initiated a severe international economic depression in Europe and the United States that lasted until 1879. It began with bank failures in Vienna (then capital of Austria-Hungary) which spread to most of Europe and overextended American banks. In the autumn of 1873, Jay Cooke & Company, a major firm in the U.S. banking industry, was unable to market several million dollars of Northern Pacific Railway bonds and with its credit rapidly eroding, declared bankruptcy on September 18th. The failure of the Jay Cooke bank ignited a chain reaction of bank failures, while factories began to layoff workers, as the U.S. slid into a depression. The New York Stock Exchange closed for ten days starting September 20th. According to the Wikipedia Encyclopedia, of America's 364 railroads, 89 went bankrupt. A total of 18,000 businesses failed between 1873 and 1875 and the unemployment rate reached 14% by 1876. Construction work halted, wages were cut, real estate values declined and corporate profits evaporated. In short, this was the beginning of the first Kondratieff Winter when an excessive amount of debt led to deflation, a credit crunch and ultimately, an outright economic depression.

Similarly, in May 1931, Austria played a prominent role in global economic events when the largest bank in central and Eastern Europe, the Viennese Credit-Anstalt, collapsed and led Europe into a financial crisis which was to sweep most countries off the gold standard within a few months. The ensuing panic ignited a chain reaction with a run on German, Polish and Czechoslovakian banks in June and July; the withdrawals from banks in London and Britain's abandonment of the gold standard in September; the large-scale withdrawals from New York banks in September and elsewhere within the U.S. until January 1932. This collapse of the global monetary system, culminating in the United States' abandonment of the gold standard in 1933, was the beginning of the second Kondratieff winter and the ensuing Great Depression.

At Long Wave Analytics, we have long been anticipating the arrival of the current global monetary crisis. In our January, 2003 publication we stated: "In the previous Kondratieff winter, which started with the collapse of U.S. stock prices in 1929, the world monetary system, based on gold, collapsed, following Great Britain's abandonment of gold in September, 1931. The simple reason for the failure of the monetary system at that time was because it was too restrictive. At that time governments were unable to print excessive amounts of money to fight the growing economic calamity. It is for exactly the opposite reason that this Kondratieff winter will see the collapse of the international monetary system. A paper money system imposes no restrictions on the amount of money that can be produced. Unforfortunately, the U.S. has taken maximum advantage of that prerogative, and as a result has created an enormous debt bubble, which will now collapse into the Kondratieff winter. This collapse will lead to the disintegration of the world monetary system, based on the dollar."



The above New York Times European Web of Debt (in terms of U.S. dollars) illustrates how inextricably entwined euro members' debt obligations had become by December 31, 2009:

- Italy owes France $511 billion (20% of France's GDP)
- Portugal owes Spain a net of $58 billion
- Portugal owes Britain 24 billion
- Spain owes France $220 billion
- Greece owes Germany $45 billion
- Spain owes the U.K. $114 billion
- Greece owes France $75billion

Within the last two years in particular, massive government fiscal and monetary stimulus made it possible for many euro zone countries to delay dealing with their fundamental economic imbalances. Greece used the financial cover offered by a new continental currency to overspend, over borrow and over expand. Indeed, the Greek government increased its national indebtedness to such lofty heights during the early part of this decade that no palpable exit strategy seemed possible. If Athens manages to keep its drastic austerity promises to dramatically cut government spending and turn a nation of tax evaders into taxpayers; it could unleash a brutal deflationary economic spiral of falling prices, rising unemployment and declining government revenues. Naturally, any new infusion of financial challenges, such as debt servicing costs, or debt refinancing problems, will serve to increase the difficulty of reducing deficits and the national debt.

A month ago, Greece received a 110 billion euro (150 billion U.S.) bailout package designed to shield the country's outstanding bond issues from debt speculators and restore confidence in the falling euro. The historic deal among finance ministers of the 16 nations in the euro currency bloc, the first such financial aid package for a member since the euro zone was created in 1999, has the European Union contributing 80 billion euros of the total, at an interest rate of about 5%, with the International Monetary Fund (IMF) supplying the rest. Prime Minister Papandreou is on record as having vowed: "Our priority is to avoid (sovereign) bankruptcy and that is a red line that cannot be crossed. I have done and will do everything so the country does not go bankrupt. This will give us breathing space and the time we need to make great changes. I want to tell Greeks very honestly that we have a big trial ahead of us." Indeed, the austerity measures must be followed by the paring of Greece's bloated bureaucracy, reforming the pension system, cutting subsidies to poorly managed state-controlled companies and streamlining the business permits system.

After weeks of nationwide protests and riots over the country's plans to raise a broad range of taxes and to introduce sizeable spending cuts, the Greek parliament assented to a draconian tax reform package. It includes a 90% tax on all bonuses in banking and financial services, as well as a quadrupling of taxes on dividends in portfolios to 40%. The country's fabled Aegean seaside villas will be levied with a 20% surcharge; as well as property taxes that will triple for legions of foreign villa owners who holiday in Greece. The new tax laws forbid cash transactions in excess of $2,000 (U.S.) at businesses, requiring they be paid with cheques or credit cards, under the threat of business forfeiture. Moreover, some of Greece's most notorious tax deductions are being abolished. For example, lawyers and taxi drivers, who are among the self-employed will forfeit their long-held income tax rates of as low as 5% and now must pay a 40% tax on incomes above $52,000 (U.S.). Both the middle class and the affluent are being given tax increases immediately. Any household making more than $82,500 (U.S.) per annum will pay a 40% tax; while those with incomes over $130,000 (U.S.) will pay a new top rate of 45%, each amounting to a 5 percentage point hike.

While the European Union (EU), IMF and the Greek government expect the package of austerity measures to cause a 4% contraction in gross domestic product (GDP) this year, they don't forecast a return to economic growth any earlier than 2012. In a May 5th. report, the IMF stated it expects Greek unemployment to climb to 11.8% this year from 9.4% in 2009, before peaking at 14.8% in 2012. Government data show that unemployment among Greeks between the ages of 15 and 24 was already at 32% in February. Over the past few months, the number of Greeks enquiring about positions abroad, attending job fairs of foreign employers, or just leaving the country, has increased. Many experts think the flow may soon turn into a flood, as the harsh reality of the economic downturn worsens and the unemployment rate continues to rise. Greece, traditionally one of Europe's poorest countries, saw hundreds of thousands of its citizens leave for the United States and other countries in search of work, during the early part of the 20th. century. The post Second World War years witnessed another wave of Greek immigrants searching for employment opportunities in Germany, Australia and Canada; as well as the United States. According to experts, what sets the current economic trend apart and makes it particularly worrisome, is a slow, but steady "brain drain" as the country's best and brightest seek employment opportunities abroad. Thus, erodes the country's professional talent which could have positively impacted Greece's long-term ability to revitalize itself into a modern, competitive economy.

Greece is also planning to raise more than 3 billion euros by selling stakes in some of its poorly managed state-owned businesses. At a recent news conference, Finance Minister George Constantinou declared: "Our objective is to have a state which guarantees public services, but at the same time taps the dynamism of Greece's economy." Outlined below are a few of the government assets which Greece plans to sell:

- A 49% stake in fully state-owned railway OSE, which has losses of about one billion euros a year and estimated debts of approximately 10 billion euros
- A 10% stake in Athens Water and a 23% stake in Thessaloniki Water
- A 39% stake in Hellenic Post, retaining a 51% majority stake

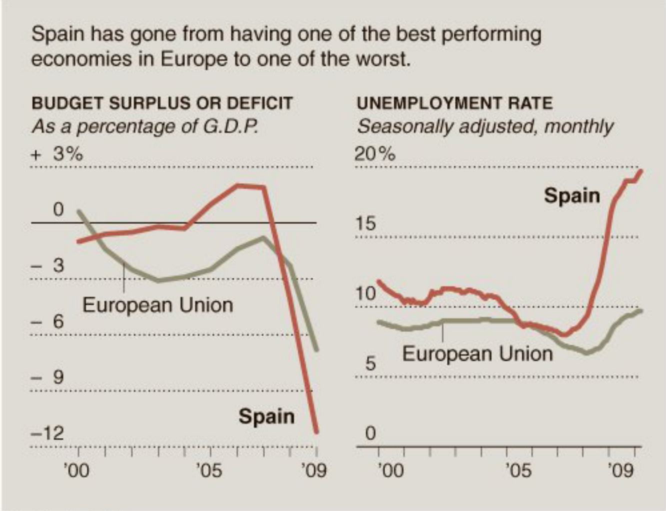
As a result of Greece's multiplicity of economic troubles, European Union finance ministers have recently agreed at a Luxembourg meeting, to tighten oversight of national government's budgets and root out any falsification of economic data. Striving to avert a further loss of confidence by the currency markets in the euro, the ministers have also agreed upon a new safety net of 440 billion euros, or $526 billion (U.S.), for other debt laden members of the euro zone. Under the agreement, the facility will be based in Luxembourg and will use government guarantees to raise funds for countries at risk. Each euro zone country will guarantee 120% of its pro rata share for each bond issue, to cover that of any country unable to contribute. The 27 finance ministers also agreed on the need for European countries to shift from stimulus to consolidation by 2011 at the latest. There was also solid agreement to allow Eurostat, the EU's statistical agency, to audit countries suspected of falsifying economic data. Moreover, at his most recent monthly news conference, European Central Bank (ECB) President Jean-Claude Trichet emphasized that all of the ECB's recent purchases of euro zone government bonds (quantitative easing) are temporary and don't represent a change to monetary policy.

Under the terms of the 110 billion euro loan with the European Union and the International Monetary Fund cited above, Greece aims to reduce its budget deficit to 8.1% of gross domestic product this year from 13.6% in 2009. Interestingly, Greece's Finance Ministry issued a statement last week declaring: "According to the preliminary data available, for the state budget implementation for the first 5 months of fiscal 2010, the deficit amounted to 8.973 billion euros, versus 14.655 billion euros during the same period of 2009. Consequently, (the deficit) declined by 38.8% against an annual reduction target of 35.1% in the Stability and Growth Program, including additional measures instituted in March 2010. Ordinary budget net revenue rose by 8.3% from a year earlier, against a full year target of 11.7% for 2010. However, ordinary budget expenditures for the same period declined by 10.6%, against a targeted reduction of 4.8% for 2010. In particular, primary expenditures declined by 11.3% against an annual reduction target of 4.4% and interest expenditures declined by 7.5% against an annual reduction target of 5.1%."

The Pain in Spain Is Likely To Remain (2)

Two weeks ago, the Spanish government of Jose Luis Rodriguez Zapatero narrowly won approval for an extra 15 billion euros, or $18.4 billion (U.S.), in spending cuts; in an effort to bring the budget deficit down to 6% of the gross domestic product (GDP) by 2011, from the 11% recorded in 2009. In light of the international rescue package for Greece (cited above), investors want Spain to demonstrate that it can reduce its bloated fiscal deficit fast enough to avoid emergency aid. Given the size of the Spanish economy, a bailout would be much more costly than the Greek effort. Yet a debt default or severe restructuring would be even worse, crippling foreign banks whose lending has underpinned Spain's debt escalation. Adding to the government's woes, labour unions (as is the case in Greece) have begun to rally against Mr. Zapatero's plans for change. Spanish public workers went on strike last week against a 5% average reduction in their wages this year; but it is widely expected to be the prelude to more severe labour unrest later this month, after the government unveils plans to overhaul Spain's labour laws on June 16th. The country's two main unions have been at odds with employers regarding potential improvements to the labour market and have warned of a general strike should the government present a "hurtful" reform plan.

According to the World Bank, Spain has some of the highest firing costs for open-ended contracts in Europe, which has encouraged employers to place 25% of the country's work force on temporary contracts. Certainly, that dynamic contributes to rapid fluctuations in Spain's employment levels, with the jobless rate nearing 20%, double the European Union's average.



Source: Eurostat

This week, as part of his labour reform, Prime Minister Zapatero is expected to propose a significant cut in redundancy costs for companies, reducing the payment that fired workers on long-term contracts are guaranteed for each year of employment, to as little as 20 days from the current 45 days. A second priority of the reform may be to loosen the rigid system of collective bargaining that prevents companies from agreeing to their own terms with employees; even forcing them to follow different rules in different regions. Also, the government is expected to take additional steps which focus on increasing state revenues to help reduce the fiscal deficit, amid concerns about Spain's economic growth prospects. According to the newspaper El Mundo, the government is also considering a fiscal amnesty, which would seek to repatriate about 50 billion euros held offshore, by granting tax evaders a pardon, in return for investing in Spanish debt securities at below market yield levels.

During Spain's decade long construction and real estate boom, many savings banks (cajas de ahorro) grew very quickly because they made significant loans to local real estate developers, due to their strong ties to regional governments and communities. As Spain's housing bubble began to deflate and its economy stagnated, the savings banks saw their bad loans increase at an alarming rate. Now, 34 of Spain's 45 existing savings banks are involved in merger talks, as the central bank and the government attempt to strengthen the banking sector. Caja Madrid, Spain's second largest savings bank by assets, is in talks with Bancaja involving an ambitious merger with five other savings banks, that would create the biggest private financial institution in the country. Indeed, the new group would create a banking giant with 340 billion euros ($407.56 billion U.S.) in assets, more than competitor La Caixa of Barcelona, which has 280 billion euros in assets. Merger activity within cajas have gained traction in recent weeks as international investor concern grows over the government's fast-rising debt. Both Caja Madrid and La Caixa are widely viewed as leading consolidators, due to their solid financial strength and large market share. Their combination could secure up to 4.5 billion euros from Spain's restructuring fund called FROB, which is financed by the government and managed by the Bank of Spain, to help them fund the merger costs and reinforce their capital.

The Exposure of the Banks

Spain's banks are finally being restructured, a full two years after it was quite apparent that Spain's real estate market, once Europe's hottest, was in ruins. A Madrid economics consultant, Jose Manuel Amor Alameda, recently commented to the media: "If the current restructuring process is slow, or the problems within the financial institutions are not addressed, we run the risk of having a sizeable chunk of the Spanish banking system acting as a zombie for the next three to five years. This would have enormous repercussions for the macro picture in Spain and in the euro zone. Even though there is no political or fiscal union, the links between the financial systems and economies are so deep." Spain's economic boom years were funded in the capital markets by the sale of nearly one trillion euros of securities, some of them mortgage-backed bonds issued by the banks. By estimation, at least 40% of these securities are owned by European banks, pension funds and other institutional investors. These restructured cajas are regulated and operate like commercial banks, but have no private owners and do not issue public shares. Rather, they are mutually owned by stakeholders such as regional and city governments and distribute some of their profits to charities and community projects.

Traditionally, home ownership was not part of the family asset mix in Spain. The cajas helped to change that by using ultra-cheap mortgages to compete with the big banks, such as Santander and extend their reach into communities. At times, they offered mortgages at only half a percentage point above Libor, the London interbank offered rate, in the hope of recruiting customers for life. Spain's construction boom, bankrolled by the cajas enabled the country to be Europe's job creation engine in the early years of this decade. Research by Morgan Stanley indicates Spain added 2.8 million houses over five years, but after the bubble burst, 1.5 million houses were left unsold. In the suburbs of the big cities, fully built housing estates remain abandoned. If Spain's real estate market continues to slide, it could cause serious funding problems for the cajas and ignite another European banking crisis.

Summary

Investors are, not only worried about European banks' exposure to individual EU countries, but also about the inter-linkage of that exposure. According to the Bank for International Settlements (BIS), outstanding loans by the global banking community (excluding domestic banks), to the public and private sectors in Greece, Spain, Portugal, Ireland and Italy, the five Euro zone economies currently considered the most risky, was $4 billion (U.S.) at the end of 2009. European banks' exposure accounted for 75% of this total, while the French banks comprise nearly one third and the German banks almost one quarter. (See above chart – European Web of Debt). As mentioned above, worries about the size and quality of banks' exposure to those economies are entwined with concerns about their ability to fund themselves. In its recent semi-annual financial stability review, the European Central Bank (ECB) noted that European banks must write off a further 195 billion pounds of bad debts by 2011. The ECB also warned: "The main risks for the Euro area financial system include the possibility of concerns about the sustainability of public finances persisting, or even increasing with an associated crowding-out of private investment."

While the worst case scenarios, such as a default or debt restructuring by a Euro zone government may appear unlikely at the moment, it will only be a matter of time. There is no doubt that the challenges for European banks are exacerbated by the sector's own structure. Greece and Spain, notwithstanding, Portugal, Italy and the United Kingdom are all still fiscally challenged by a bloated network of domestic banks. Accordingly, we foresee further weakness emerging in the euro currency against the U.S. dollar, temporarily, as investors continue to naively and erroneously seek out U.S. dollar denominated investment securities as a "safe haven."

However, we believe investors will gradually wake up to the shocking reality of the states' deficit outlook, led by Illinois, California and New York; combined with the federal debt nightmare which could reach $14 trillion (U.S.) by the end of 2010. Moreover, post November's mid-term elections and December's national debt report from the National Commission for Fiscal Responsibility, we foresee a domestic economic civil war erupting mainly over tax increases on many fronts and entitlement cuts to medicare, medicaid and social security. Not only, do Americans reject the idea of cuts to their benefits and entitlements, but also, they are not willing to accept higher levels of taxation.

We believe we have just witnessed the end of the beginning of the third Kondratieff winter. Once again we witness Europe as the instigator of this economic crisis. As previously mentioned, we have long been predicting an ugly outcome for this unfolding financial disaster. While United States' monetary printing presses are operating at full throttle, we perceive America being overwhelmed by the very debt it eventually seeks to eradicate. We believe there is no way that America, the world's largest debtor nation, can generate enough economic growth to solve its deficit and debt problems. As such, we foresee the inevitable collapse of the world fiat monetary system and the end of the U.S. dollar as the world's reserve currency. It is for the above reasons that we have been such long been strong advocates for the higher value of gold bullion and gold mining company shares.

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