

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER



“The Credit of Bank Notes (Paper Money) Has Been Emphatically Denominated Suspicion Asleep”
- William Corbett, “Paper Against Gold”, 1810

At this time, given the huge worldwide debt problems, suspicion is wide awake.

The Poster Child for Bankrupt American Cities

Welcome to Harrisburg, Pennsylvania, the state capital, whose mayor would rather borrow than reduce costs. Harrisburg’s financial problems gradually worsened when debt on an electricity-generating incinerator accelerated from \$12.5 million (U.S.) to \$310 million (U.S.) after three decades of overhauls and upgrades, eventually burdening the city with annual interest costs which now exceed its budget. Like the majority of other cities across America, Harrisburg’s revenues were derived mostly from property taxes. However, this traditional revenue source has been drastically reduced in recent years due to the national housing crisis and declining property values. Mayor Linda Thompson, voted into office in 2009, had defied pressure from the state government and bondholders to initiate job layoffs and sell selected assets. In an interview about a year ago, Mayor Thompson remarked: “To disrupt (municipal services) because we can’t make a bond (interest) payment would just be unconscionable. As a leader, I couldn’t do it.”

Obviously, Mayor Thompson never studied Economics 101 in college. If the city is not going to honour the interest payments on its outstanding debt obligations (that’s what’s unconscionable), which investors does Mayor Thompson think will be keen to participate in the city’s next new bond issue? Mercifully, Mayor Thompson was recently outflanked by the Harrisburg city council which voted by a narrow majority to commence bankruptcy proceedings. In a media interview, Richard Harper, owner of a local financial services company, commented: “Harrisburg is just a microcosm of what’s going

on throughout the United States. You can’t continue to burn more money than you’re bringing in.” With the commencement of bankruptcy proceedings, Mr. Harper has become very concerned about the quality of life in a city where nearly 30% of the population lives below the poverty line and city outskirts are dotted with abandoned homes. Mr. Harper has recently bought a gun permit and plans to move his business outside of Harrisburg.

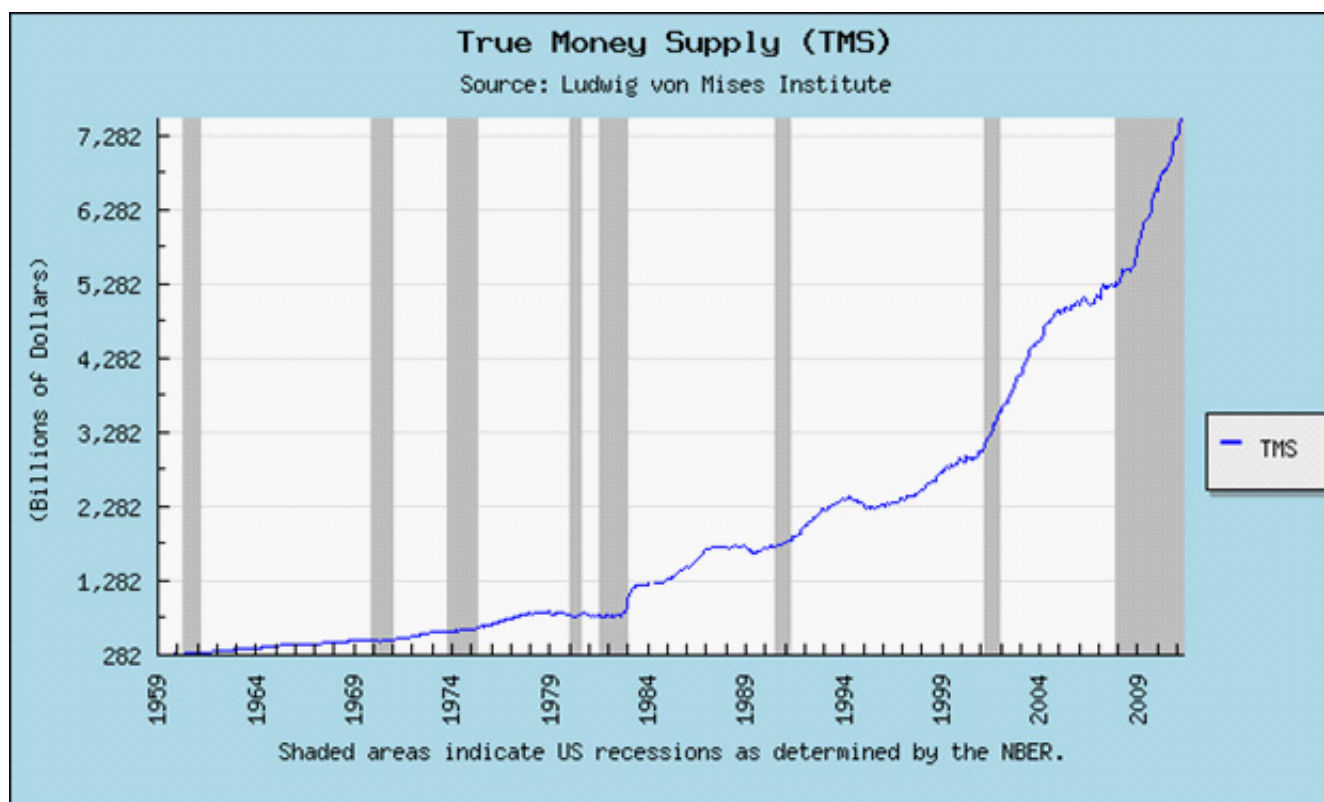
The U.S. Bipartisan “Super Committee” Attempts to Justify its Nomenclature

According to Thomson Reuters, hard bargaining by a special U.S. deficit-reduction panel is entering a more intensive stage. The “super committee” – an outgrowth of an August federal budget deal that has also raised the U.S. borrowing authority – has until November 23rd. to fashion an agreement, with the full U.S. Congress facing a December 23rd. deadline for final action. If there is a failure on either end, automatic budget spending cuts totaling \$1.2 trillion (U.S.) would commence in 2013. Obviously, the success or failure of the “super committee” will not only, have an impact on the future fiscal health of the United States, but its decisions could also loom large in presidential and congressional elections in November 2012. During a recent speech to the Council of Foreign Relations in New York, Congressional Budget Office (CBO) Director Douglas Elmendorf commented: “What we are doing right now very intensively, is giving “super committee” members and staff, estimates of the budgetary effects of the different proposals which they are considering. The ‘super committee’ is clearly engaged very seriously on a long-term budget plan and is discussing issues such as revenue increases, which most Republicans have strongly resisted to date.”

Naturally, the CBO will play an important role in the “super committee’s” deliberations. Being the non-partisan budget analyst for Congress, it will assess the impact any eventual agreement would have on government budget deficits, which have exceeded \$1 trillion (U.S.) in each of the past three years. Since no decisions have yet been made regarding raising revenues or cutting expensive health care programs, the panel has not yet determined whether to aim for the required \$1.2 trillion (U.S.) in savings, or attempt a much larger agreement that the financial markets would prefer. The “super committee” has been meeting in secret for more than a month, discussing whether to focus on spending cuts, tax increases or both. For all the tirades launched against the euro zone leadership, America’s economy risks being dragged into a depression not only, by its own fiscal policy, but also, by the fact that both political parties are more interested in positioning themselves for the 2012 elections, rather than in arriving at the budget compromises so desperately sought by the American electorate.

The Exponential Growth in U.S. Money Supply

According to a report in Gold/Money, author Alasdair McLeod expounds: “With all the troubles of Europe hogging the headlines, commentators are ignoring money supply in the United States, which is growing strongly, with the broad measure of M2 growing by over 10% for the last 12 months. Furthermore, the annualized growth rate over the last six months has been above 15%. The story told by the True Money Supply (TMS), otherwise known as Austrian Money Supply, confirms this ... According to the Ludwig von Mises Institute, it represents the amount of money in the economy available for exchange. Furthermore, it is designed to clearly show any expansion that results solely from central banks injections of cash and commercial banks’ credit creation, by excluding everything that has to be converted into cash first, such as credit and money market funds. It is, therefore, a pure measure of money in the economy available to be used for transactions ... In economic theory this is important, because money is simply a commodity which happens to be used exclusively as a medium of exchange. As a commodity, its value ultimately depends upon the supply and demand for it. By using TMS, we keep the relationship between actual money and prices pure from other arguable factors. The growth in U.S. dollar TMS over the long-term is shown in the chart below. From this chart it can be seen that following a pause in its long-term trend, at the time of the 2007-2008 financial crisis, TMS has been growing strongly ever since.



The bulk of the growth has been in cheque deposits (customer current accounts) and savings deposits (instant access accounts) at the banks. Some commentators point out that this reflects cash not being spent and cash representing risk-adverse hoarding. However, this opinion ignores the fact that the cash is being used, because the banks have loaned it to the government and the government is distributing it into the economy. So, this cash does amount to extra supply of money, which will be gradually reflected in a decline in its purchasing power. Given that the acceleration in TMS dates back to 2009, we are already seeing this with ShadowStats.com, which applies an unbiased statistical rigour to key statistics, estimating actual inflation to be running considerably higher than official estimates. The other aspects ... of the pricing effects of supply and demand, is the variability of demand for individual goods. As always, here the picture is uneven. Welfare, defence and healthcare spending by government maintain demand for energy, food, defence and healthcare related items. Banking and related financial services are also doing well, despite balance sheet problems, since they are closest to the source of the new money (in this case, the Federal Reserve). Much of the rest, as business surveys and unemployment statistics confirm, is patchy at best. So, there are identifiable winners and losers in pricing and the expansion of TMS is feeding through to those goods, demand for which is supported by government spending. With this monetary background, it is likely that the big headache for 2012 will be persistent and rising price inflation for the United States and other economies tied to the U.S. dollar. So, we can expect stagflation to be in everyone's vocabulary in the New Year, which will inevitably lead to pressure for interest rates to rise sooner rather than later.

The Poster Child for Bankrupt American States

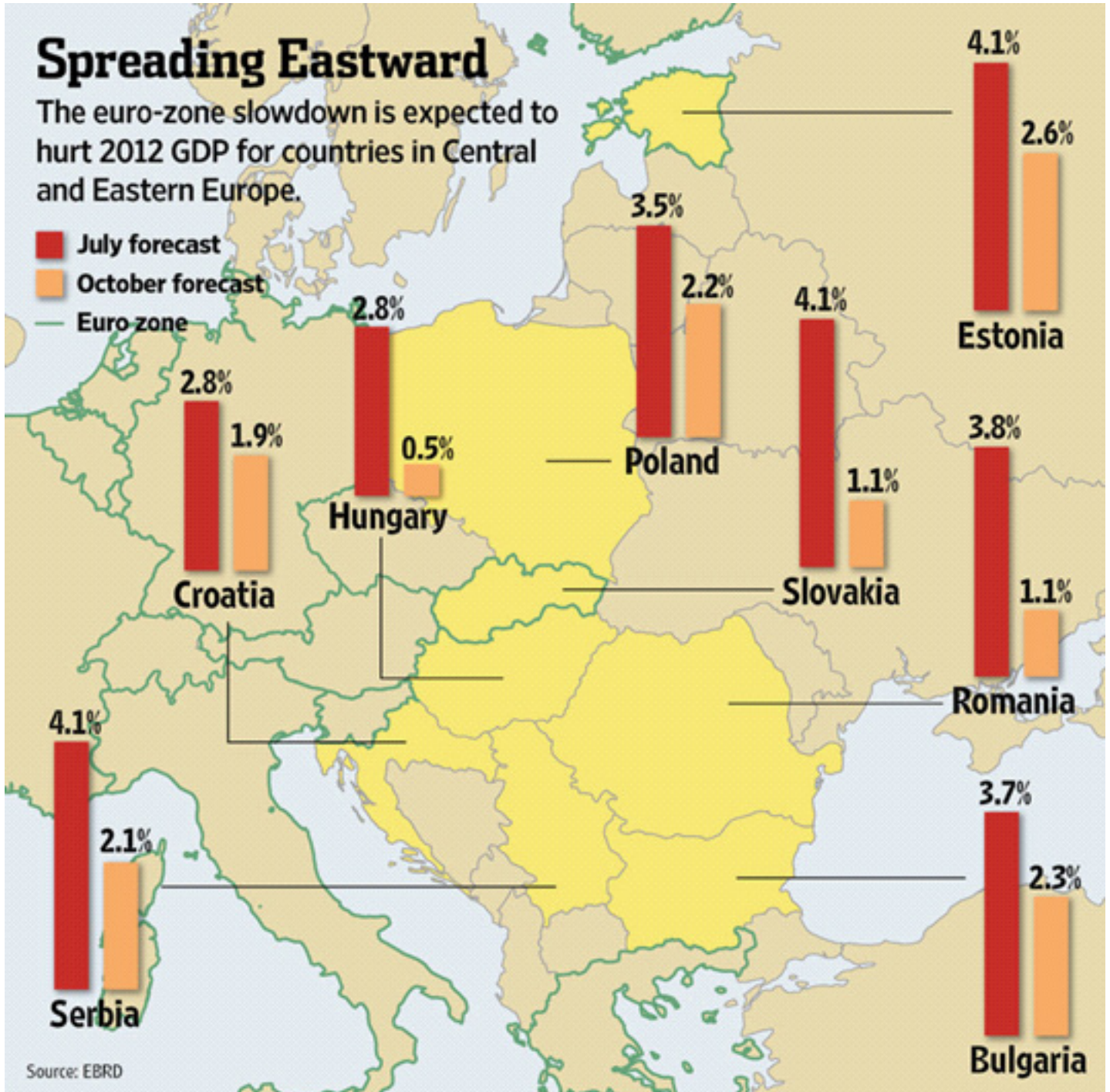
Welcome to Rhode Island, the Ocean State, territorially, the smallest state in the union, but faced with a tsunami of debt. After decades of denial and treading water, Rhode Island's \$14.8 billion (U.S.) pension system has reached the crisis stage. At present, 10 cents of every State tax revenue dollar is expended on retired public workers and projections are that number could double sooner rather than later. Until this year, Rhode Island has been calculating its pension obligations assuming that its various funds would realize an average annual rate of return on its investment portfolio of 8.25%; when the actual rate over the last decade has been closer to 2.4%. Recently, the State General Assembly convened a special session to propose scaling back benefits for public employees, including retired workers. Last August, the City of Central Falls could persevere no longer and filed for bankruptcy protection, rather than honour its pension obligations to its retired firefighters and police officers. Nationally, combined state and local pension funds are underfunded by a staggering \$3 trillion (U.S.). Having reassured bondholders that interest on its outstanding debt obligations represent a priority, nonetheless, Rhode Island's pension funds are gradually being depleted. Similarly, the State's infrastructure (roads and bridges) ranks among the worst in the country and the official unemployment rate stands at 10.6%. Having made several unsuccessful attempts since 2005 to prevent the pension ship from listing to port, it is now beginning to look like the capsizing of the ship is inevitable.

Eastern Europe – The Euro Zone's Other Half

In a report outlining the economic prospects for the 29 countries in which it invests, The European Bank for Reconstruction and Development (EBRD) warns: "The damage inflicted on the euro zone's eastern neighbours could be even greater if larger economies such as Italy and Spain are frozen out of international bond markets, leading to a possible failure of some large euro zone banks.

If euro zone leaders fail to resolve the crisis soon, the impact on Central and Eastern Europe will be more severe. In the downside scenario ... the crisis is not contained before spreading to the larger single currency area members, which in turn renders several European banks insolvent. This scenario implies prolonged market turmoil and a western European recession with negative spillovers for the global economy, contributing to a downturn in the U.S. and subsequent lower commodity prices."

In a related interview, EBRD Deputy Chief Economist Jeromin Zettelmeyer commented: "With time running out, euro zone leaders may finally be prepared to take the appropriate steps. When things get very bad, you sometimes get a breakthrough in thinking. Part of the problem over the last few months has been denial, but denial is becoming more difficult. However, economies in central and eastern Europe with close trade and financial links to the euro zone will slow sharply next year as a result of the currency area's twin fiscal and banking crises."



Western Europe – “The Euro Is a Cobbled Currency Which Will Never Survive the Kondratieff Economic Winter” – Ian Gordon, Long Wave Analytics, 2003.

As far as the Euro zone sovereign debt crisis is concerned, this is a long, complicated and enormous exercise which will, not only test the mettle of the fixed income market, but also, is predictably unlikely to end happily. European Union (EU) leaders are discussing plans to recapitalize their banks, ease the debt burden on Greece via another bailout and enlarge the European Financial Stability Facility (EFSF). Apparently, many EU leaders have already written off the Brussels Summit and are now looking to the G20 meeting in Cannes in Novem-

ber to resolve the debt crisis. In other words, the EU is “kicking the can down the road again” with respect to many details and aspects of any agreements in these areas of concern. French President Nicolas Sarkozy said he plans to ask Chinese leader Ju Jintao if his government would put money into an investment vehicle that would buy the bonds of troubled EU countries.

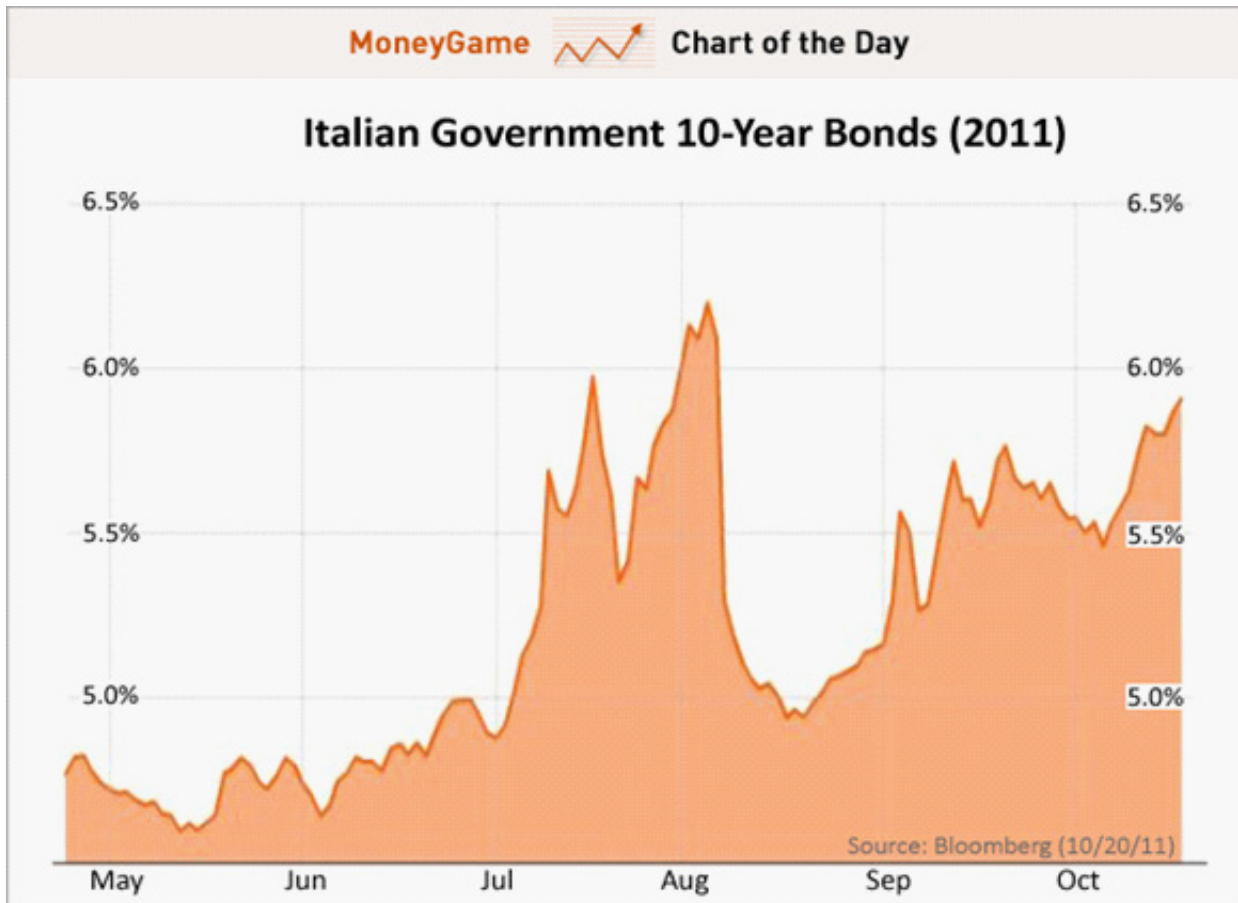
The EU Agrees in Principle with Bondholders on 50% Haircuts for Greek Debt

Greece’s economy has deteriorated so severely in the last three months that international lenders would have to find 252 billion euros (\$353 billion U.S.) in bailout loans through the end of the decade, unless Greek bondholders voluntarily accept severe cuts in their debt repayments. This bleak analysis, contained in a report by international lenders and obtained by the Financial Times, is more than double the 109 billion euros in the European Union (EU) and International Monetary Fund (IMF) aid agreed upon only three months ago. The analysis stated: “Under a more severe test run by economists for the so-called “troika” of lenders – the IMF, European Central Bank (ECB) and European Commission (EC) – Greece’s bailout needs could balloon to 444 billion euros.” European leaders are considering “haircuts” on Greek bonds far higher than previously known. In order to bring a second Greek bailout back to the 109 billion euro amount agreed upon last July, bondholders would have accepted a 50% loss on their current Greek debt holdings. That is significantly more than the 21% haircut agreed upon with private investors just three months ago. Recent developments called for a reassessment because the situation in Greece had taken a turn for the worse. **It is an open question whether other countries or institutional lenders will support additional loans to Greece at preferred rates of interest.**

Italy Pledges Asset Sales to Reduce Debt

In a letter of intent, presented to EU leaders at the Brussels summit, Italian Prime Minister Silvio Berlusconi vowed to balance the country’s budget by 2013; raise 5 billion euros (\$8 billion U.S.) annually from asset sales; increase the retirement age to 67 by 2026 and relax labor laws, to convince euro zone leaders that Italy can reach its budget goals. “We are aware that we must present a comprehensive plan of reforms. We are aware that our debt is too high and our (GDP) growth is too limited. The asset sales plan will be completed by November 30th.” Within the euro zone’s largest sovereign debt market, Italy’s public debt has grown to 1.9 trillion euros, representing 120% of gross domestic product (GDP). Mario Draghi, Italy’s central banker, who is poised to assume the governorship of the European Central Bank (ECB) on November 1st., termed the current situation in Italy both “confusing and dramatic.” Indeed, internal parliamentary tensions boiled over last week when government officials engaged in fisticuffs over the reform plans.

Jean-Claude Juncker, Prime Minister of Luxembourg reflected: “Our Italian friends know well that we had to assume ... there will be significant structural consolidation efforts from Italy. That is a must.” The prospect of Italy falling to contagion would prove a much greater problem for the EU than the insolvency of Greece. Yields on 10-year Italian sovereign bonds have increased to just above 6%, near the level which prompted intervention by the ECB last August. **At Long Wave Analytics, we are of the opinion that the Italian budget cannot afford to pay 6% for 10-year funds and hope to reduce its debt to GDP. Somewhere within the 3% to 4% yield range is all the budget can withstand. (See chart below.)**

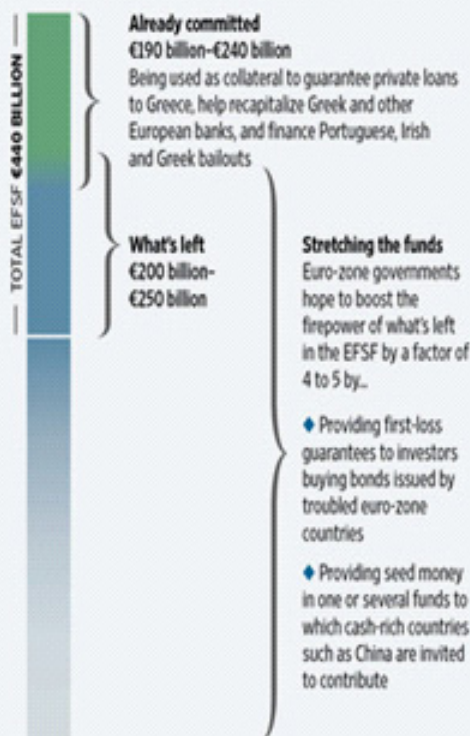


China Ponders Jumping from the Frying Pan into the Fire

Klaus Regling, Chief Executive Officer of the European Financial Stability Facility (EFSF) flew into Beijing last Friday, on the first stop of an Asian tour, seeking out financial support for the EFSF. At a recent EU summit in Brussels, euro zone leaders agreed to leverage the 440 billion EFSF to 1 trillion euros. In a news conference, Mr. Regling informed reporters: "I don't expect any precise outcome from this visit to China and it's too early to say what kind of amounts might be envisioned. This trip to Asia is about consulting with investors over the best way to structure additional funding." ZHU Guangyao, Chinese Vice Finance Minister responded: "China must first see the details of a new European bailout fund before making any commitments. Of course, we must wait until its structure is extremely clear. Moreover, this investment must be decided upon after serious, technical discussions. European leaders should turn policy commitments into real action. EU leaders should take serious action to solve questions the (fixed income) market needs." According to Li Daokui, an academic member of China's central bank monetary policy committee: "Any Chinese support would depend upon contributions from other countries and Beijing must be give strong guarantees on the safety of its investment. It is in China's long-term and intrinsic interest to help Europe because they are our biggest trading partner, but the chief concern of the Chinese government is how to explain this decision to our own people. The last thing China wants is to waste the country's wealth and be seen as a source of dumb money."

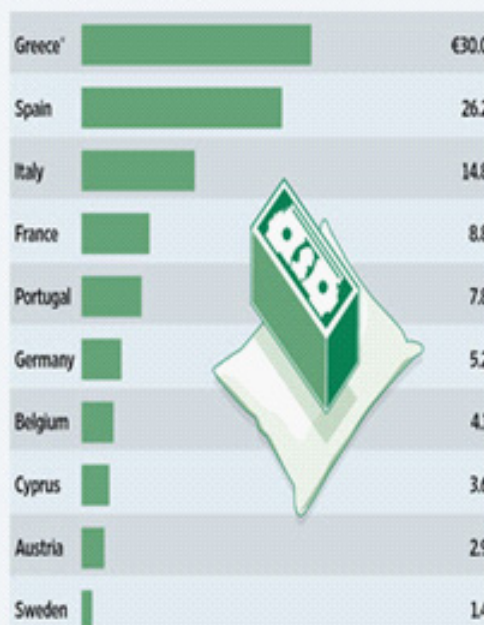
The Plan | Leaders outlined broad measures to tackle the euro crisis, though much remains uncertain

EXPANDED THE LENDING POWER OF THE EFSF



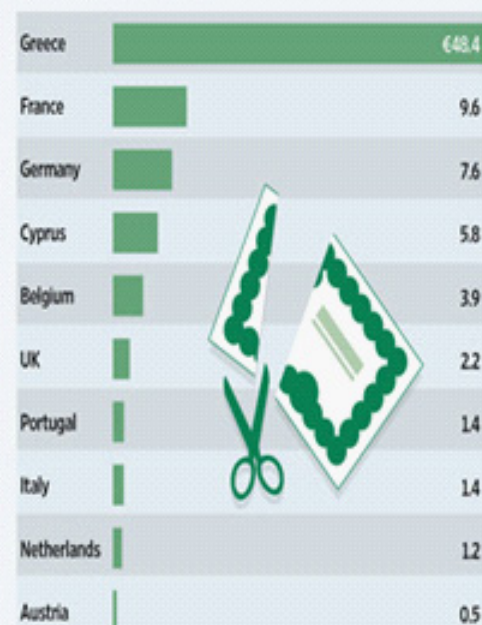
ASKED EUROPEAN BANKS TO HOLD BIGGER CAPITAL CUSHIONS

Estimated new capital buffer needed by European banks, selected countries, in billions of euros



HAD INVESTORS TAKE A 50% HAIRCUT ON GREEK DEBT

Top banks' total holdings of loans and sovereign debt from Greece, by country, in billions of euros¹



Note: €1 billion = \$1.39 billion; *EBA didn't specify the size of the Greek shortfall, but said that the existing €30 billion government facility would be sufficient to cover the expected shortfall; ¹As of Dec. 31, 2010; Source: European Banking Authority (capital cushions, debt holdings)

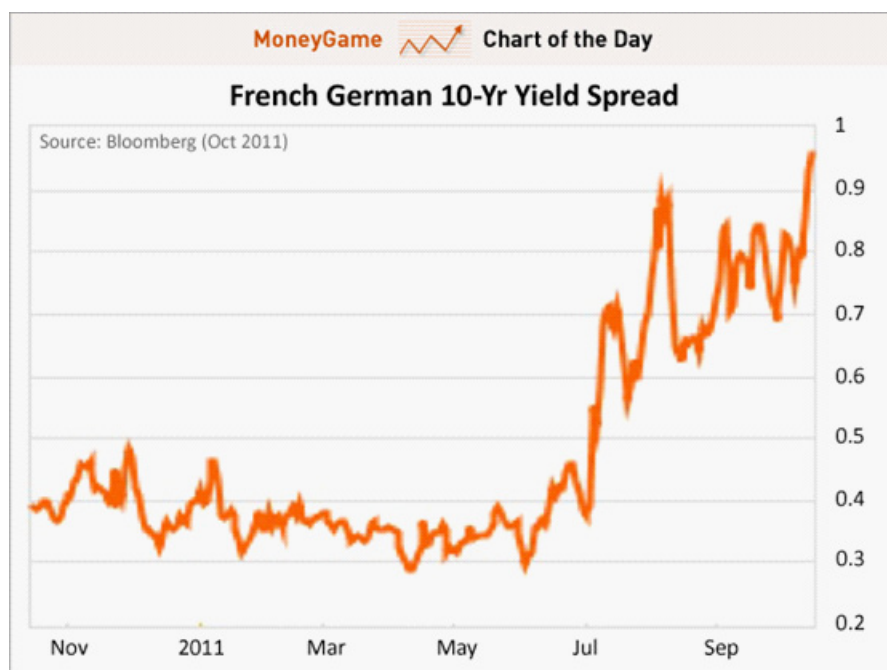
Only God Can Save Us

The Greek people have been protesting, striking and occasionally, rioting against Greek Prime Minister George Papandreou's austerity measures, which include significant wage cuts and job losses in a depressed economy already struggling with an unemployment rate of 16.5% and rising homelessness. CMC Markets analyst Michael Hewson warns: "the question is whether another bailout will be enough in the long term, or whether it has merely postponed the day of reckoning for a little while longer. While we now have some numbers to contemplate, it will be all rather pointless if leaders don't find a way to stimulate (economic) growth and we still have the question of Italy's finances." Elsa Lignos, senior currency strategist at RBC in London stated: "Europe's debt crisis is by no means solved. For Greece to reduce its debt-to-GDP ratio to 120% by 2020 from today's level of 160% will be hugely dependent on the path of economic growth." There are no celebrations on the streets of Athens these days. The Wall Street Journal quoted a 49 year-old book store owner who says his sales have slumped by 70% and he can't pay his rent. Also, there's piano teacher Katrina Koutrea who is "ashamed to be Greek and very angry" and who now only teaches three students because the parents of others can't afford to pay. George Kapsokalyvas, an 85 year-old pensioner, asked a Reuters news agency reporter: "What rescue? Can't they see that we've nothing left to give? Only God can save us!"

If You're Not Skeptical, You're Inclined to Be Gullible

While equity market-oriented traders greeted last week's proposed euro zone bailout plan with enthusiasm, bond and currency market traders – together with several economists – were far less sanguine and much more skeptical.

1. Richard Cookson, global chief investment officer of Citi Private Bank declared: "It's another patchwork effort. They're trying to tide things over for the euro zone and it has worked a bit today, but the half-life of the euphoria seems to diminish with every (rescue) package that comes along."
2. David Watts, senior European strategist for CreditSights mused: "It's certainly hard to see this (plan) as the bazooka that the markets have been seeking. There are very real risks that this will prove to be just another divot in the road ... Allowing a mere three years to grow the Italian economy back to the point where it can underpin market confidence is probably optimistic."
3. David Tan, international fixed income portfolio manager at J.P. Morgan Asset Management asserts: "The 120% debt –to-GDP goal for 2020 assumes that Greece will be generating a budget surplus to 4.5% of GDP by 2014 and that the Greek economy will be growing at 3% annually by 2016. In reality, the International Monetary Fund (IMF) expects Greece's economy to contract by 5.5% this year and by 2.5% in 2012, as austerity measures imposed as part of earlier restructuring efforts go into effect. If you make less heroic assumptions on (economic) growth, the debt (level) doesn't come down very much at all."
4. Mark Luschni, chief investment strategist at Janney Montgomery Scott, observed: "While 106 billion euros might allow European banks to absorb losses stemming from a Greek debt restructuring, I'm not sure that it is enough to deal with write downs on Italian debt if that country runs into trouble."
5. Constatin Gurdgiev, a finance lecturer at Trinity College in Dublin exclaimed: "Even if everything goes swimmingly, the Greek economy is going to be crippled for the next 15 to twenty years. The rescue plan is an absolute disaster across the board. The worst possible scenario is the one they came up with, where you damage the patient but you don't do anything to the disease."
6. Kenneth Rogoff, a Harvard economics professor, former chief IMF economist and co-author of the book "This Time Is Different – Eight Centuries of Financial Folly" argues: "I'm pretty skeptical that the euro zone will retain all of its members. For any long-term plan to work, troubled members like Greece and Portugal must be cast away. Those (countries) that remain must form a much tighter confederation of states. Within this more integrated union, I would advocate two major reforms: a tax policy that sends revenue to a central body, which is given the power to assist troubled countries and a common regulator that assesses the entire region's problems and keeps watch over national fiscal disparities. I think that's the only end game here."



Summation

We have long warned that the bursting of the international debt bubble would be the catalyst which would plunge the world into the long wave winter depression. In 'The Long Wave Analyst', published in January 2003, I wrote "...all my readers need to know is that, **'It's the Debt, stupid, which is the principal cause of the impending depression.'**" In like manner Gareth Garrett in his book **The Bubble that Broke the World** in which he writes about the collapse of the international debt bubble in the previous Long Wave winter, wrote "Inflation of credit-ecstasy, delusion, fantastic enrichment. Deflation of credit-depression crisis, remorse. One state succeeds the other and there is no escape, for one is cause and one is effect."

Unlike the previous winter debt collapse between 1931 and 1933, the impending collapse during this Long Wave winter is much more international in scope. During the last winter, the debt crisis was centered on Europe and on the American banks, which had been the principal creditors. In his book, Gareth Garrett devotes two chapters to the European crisis: the first is entitled "On Saving Europe and the second "The rescue of Germany." It is interesting to see the parallel between then and now. Currently the debt crisis is centered in Europe as it was then, but during this crisis Germany has taken on the major creditor role. During the 3rd. winter debt crisis the principal creditor role was undertaken by the United States with supporting casts played by Great Britain, France, Holland and Switzerland. Then, as now, the solution was to resort to even more credit to withstand the threat of national bankruptcy. So debt was piled on debt in ever increasing amounts and many in cases, certainly Germany's it was ultimately to no avail, national bankruptcy became the only option, and as a result the creditors' losses were far greater than they might have been had they refused any more credit at the onset of the credit crisis. "Europe's attack upon her debt, both internal and external, was to resort to credit. She called upon this country for immense sums of private credit-sums which before the war (World War 1) had been unimaginable-saying that unless American credit provided her with the ways and means to begin moving her debt she would be unable to move it at all." **The Bubble that Broke The World.**

As we know from following Germany's move into bankruptcy in 1931, the bailouts were never enough. Now we are witnessing a similar picture evolving in Greece, the bailouts are never enough and Greece, like Germany, will ultimately declare bankruptcy. But what of bigger European nations like Italy and Spain? They too will need more and more credit to keep them afloat. Where's that credit to come from? Certainly not from Germany, she is already close to her lending capacity. France? Hardly France, she might soon be in a similar debt predicament to that shortly to be experienced in Italy and Spain. Well, what of the United States, the great creditor nation between 1914 and 1933? Absolutely not. If current world attention was not directed at Europe's debt impasse, it would almost certainly be focused on the monstrous debt burden of the United States. China? No, China has engineered perhaps the greatest program ever of mal-investment over many years. Her internal debt bubble is about to deflate with horrendous repercussions and she will need all her money to bail out her banks and local governments.

As we have long predicted based on our knowledge of the LongWave Cycle, the gigantic international debt bubble, all made possible by thoroughly dishonest paper money, is now collapsing and no amount of additional debt will re-inflate the bubble. That process failed in the 1930s and it is failing once again in our present LongWave winter.

It is fitting that we end this writing with a quotation from Ludwig von Mises, "There is no means of avoiding a final collapse brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved." Unfortunately most of the world's currency systems have not been subject to the abandonment of credit expansion, indeed those governments that control their respective currency systems are now engaged in a desperate attempt to continue credit inflation. They cannot succeed and as a result their currencies will collapse.

These are desperate times and we urge you to read our publication "**The Death of Paper Money**", July 28, 2011.

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"Those who cannot remember the past are condemned to repeat it". Santayana