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LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER

America's Dire Debt Dilemma

As the Obama administration and the Republican-controlled House of Representatives continue to vacillate on fiscal deficit issues, the U.S. national debt maintains its inexorable climb to new heights. Indeed, with the recent Congressional agreement to suspend any potential upward adjustment in the statutory debt limit from its present level of $16.4 trillion (U.S.), at its current growth rate, by mid-May the debt level will be threatening the $17 trillion (U.S.) mark. At Longwave Analytics, we believe that there is no realistic combination of spending cuts, tax increases and rate of economic growth on the foreseeable horizon which can prevent the American national debt level from reaching new highs. What is desperately required is the political will of the U.S. Congress to address the politically sensitive issues of tax reform, government pensions and entitlements, such as Medicare, Medicaid and Social Security. However, given the moneyed power structure of the Washington lobbyist system which represents a myriad of special interest groups, such initiatives will likely prove daunting tasks.

The Sequester Budget Cuts

As recently reported in the Wall Street Journal, March 1st. is the day when $85 billion (U.S.) in spending cuts, known as the 'sequester' in Washington parlance, begin to take effect in defense and domestic programs unless Congress acts. Despite warnings about the threat to military readiness, education programs and activities across the government, both political parties state that it is likely the deadline will pass without a compromise being reached and that the spending cuts will take effect at least temporarily. The automatic-cut mechanism was arranged as part of the 2011 statutory debt limit agreement, calling for more than $1 trillion (U.S.) in deficit reduction over ten years, unless Congress enacted a budget agreement to achieve equivalent savings. That alternative may be enacted when Congress passes the continuing resolution to extend funding for government operations, which expires on March 27th. In the meantime, law makers believe, federal agencies will find administrative ways to minimize or delay the immediate impact of shrinking budgets. Senator Majority Leader Harry Reid (D., Nev.) has indicated his party would seek to avert the spending cuts. Indeed, according to senior Democratic aides, Senate Democrats have been crafting a bill they plan to introduce soon, in order to replace the spending cuts with a package of tax increases and other spending reductions which would lower the deficit by $120 billion (U.S.) over ten years. However, Senate Minority Leader Mitch McConnell (R., Ky.) has stated: *"It is pretty clear the (spending) cuts will happen and I'm just not interested in any last-minute negotiations in an attempt to avoid the budgetary belt tightening."* Senator McConnell repeated that Republicans wouldn't support any effort by Democrats to increase federal revenue to avoid or defer the spending cuts. Indeed, at Longwave Analytics, we view this attempt by Senate Democrats as a pathetic effort to reduce the U.S. deficit by an amount equal to only about 10% of what the deficit has averaged in each of the last four years of the Obama administration.

Last week, the White House issued a **'fact sheet'** describing the potential damage to government operations, including popular domestic programs such as Head Start; as well as public health and research and innovation. Likewise, the Pentagon announced it would delay deployment of the USS Harry S Truman aircraft carrier to the Middle East because of the budget constraints.

The USS Harry S Truman Source: U.S. Navy / Associated Press

White House Fact Sheet

Outlined below are some examples of how the sequester would impact middle class families, jobs and economic security:

Government Services

Food safety – The Food and Drug Administration (FDA) could conduct 2,100 fewer inspections at domestic and foreign facilities that manufacture food products while USDA's Food Safety and Inspection Service (FSIS) may have to furlough all employees for approximately two weeks. These reductions could increase the number and severity of safety incidents. Moreover, the public could suffer more food borne illness, such as the recent salmonella in peanut butter outbreak and the E. coli illnesses linked to organic spinach; as well as cost the food and agriculture sector millions of dollars in lost production volume.

IRS customer service and tax compliance – The cuts to operating expenses and expected furloughs at the IRS would result in the inability of millions of taxpayers to obtain answers from IRS call centers and taxpayer assistance centers; as well as significantly delaying IRS responses to taxpayer letters. The IRS would be forced to complete fewer tax return reviews and would experience reduced capacity to detect and prevent fraud, resulting in an inability to collect and protect billions of dollars in revenue annually. Cuts to the IRS would ultimately cost taxpayers and increase the deficit through lost revenue from recoveries; as well as additional fraud and abuse.

Native American programs – Tribes would lose almost $130 million (U.S.) in funding from the Department of the Interior. Reductions would be necessary in many areas including human services, law enforcement, schools, economic development and natural resources.

Workplace safety – The Occupational Safety and Health Administration (OSHA) may have to pull its inspectors off the job for some period of time. This would mean approximately 1,200 fewer inspections of the Nation's most dangerous workplaces, which would leave workers unprotected and could lead to an increase in worker fatality and injury rates.

Education

Title 1 education funds – Title1 education funds would be eliminated for more than 2,700 schools, cutting support for nearly 1.2 million disadvantaged students. This funding reduction would put the jobs of approximately 10,000 teachers and aides at risk. Students would lose access to individual instruction and after school programs which help to close achievement gaps.

Special education (IDEA) – Cuts to special education funding would eliminate Federal support for more than 7,200 teachers, aides and other staff who provide essential instruction and support to pre-school and school aged students with disabilities.

Head Start – Head Start and Early Head Start: Pre-school programs for children aged 3 to 5 years may be eliminated for about 70,000 pupils, reducing access to critical early education. Community and faith-based organizations, small businesses, local governments and school systems would have to lay off over 14,000 teachers, teacher assistants and other staff.

Public Health

Mental health and substance abuse services – Cuts to the Mental Health Block Grant program would result in over 373,000 seriously mental ill adults and seriously emotionally disturbed children not receiving needed mental health services. This cut would likely lead to increased hospitalizations, involvement in the criminal justice system and homelessness for these individuals. In addition, close to 8,900 homeless persons with serious mental illness would not receive the vital outreach, treatment, housing and support they need through the Projects for Assistance in Transition from Homelessness (PATH) program.

AIDS and HIV treatment and prevention – Cuts to the AIDS Drug Assistance Program could result in 7,400 fewer patients having access to the life saving HIV medications. In addition, approximately 424,000 fewer HIV tests could be conducted by Centers for Disease Control (CDC) State grantees, which could result in increased future HIV transmissions, deaths from HIV and costs in health care.

Tribal services – The Indian Health Service and Tribal hospitals and clinics would be forced to provide 3,000 fewer inpatient admissions and 804,000 fewer outpatient visits, undermining needed health care in Tribal communities.

Economic Growth

Small business assistance – Small Business Administration (SBA) loan guarantees would be cut by up to $902 million (U.S.), constraining financing needed by small businesses to maintain and expand their operations and create jobs.

Economic development – The Economic Development Administration's (EDA) ability to leverage private sector resources to support projects that spur local job creation would be restricted, likely resulting in more than 1,000 fewer jobs created than expected and leaving more than $47 million (U.S.) in private sector investment untapped.

International trade – The International Trade Administration (ITA) would be forced to reduce its support for America's exporters, trimming assistance to U.S. businesses looking to increase their exports and expand operations into foreign markets. In addition, ITA would not be able to place staff in critical international growth markets, where there is a clear business opportunity for many American businesses to increase their sales and create jobs at home. These staff would have been part of a key program working to promote and facilitate global investment in the U.S., supporting thousands of new jobs through Foreign Direct Investment.

Research and Innovation

NIH research – The National Institutes of Health (NIH) would be forced to delay or halt vital scientific projects and make hundreds of fewer research awards. Since each research award supports up to seven research positions, several thousand personnel could lose their jobs. Many projects would be difficult to pursue at reduced levels and would need to be cancelled, putting prior year investments at risk. These cuts would delay progress on the prevention of debilitating chronic conditions which are costly to society and delay the development of more effective treatments for common and rare diseases affecting millions of Americans.

NSF research – The National Science Foundation (NSF) would issue nearly 1,000 fewer research grants and awards, impacting an estimated 12,000 scientists and students, while curtailing critical scientific research.

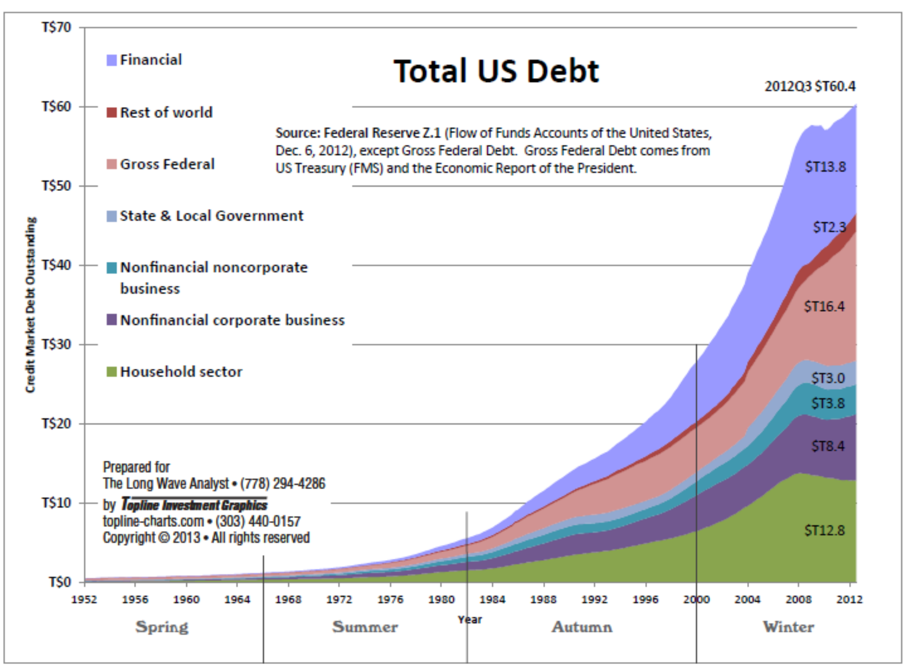
New drug approvals – The FDA's Center for Drug Evaluation and Research (CDER) would face delays in translating new science and technology into regulatory policy and decision making, resulting in delays in new drug approvals. The FDA would likely also need to reduce operational support for meeting review performance goals, such as, the recently negotiated user fee goals on new innovative prescription drugs and medical devices.

Federal Workers' Unions Protest Sequestration

As reported in the Washington Post, U.S. public servants were out in force last Tuesday, protesting potential federal budget cuts that would severely hinder their ability to serve the public. Hours before President Obama's State of the Union Address, members of the American Federation of Government Employees (AFGE), the American Federation of State, County and Municipal Employees (AFSCME), and other labor organizations gathered in a park across from the Capitol. The workers were protesting the automatic, across-the-board budget cuts which will take effect March 1st. unless Congress acts to prevent them. The reductions are designed to save $85 billion (U.S.) through the end of this fiscal year. To arrive there, agency budgets would be reduced by 9%, except for the Defense Department's, which would take a 13% hit. Employees in all agencies, except the Department of Veteran's Affairs, would probably be required to take unpaid leave of furlough days. Prior to mounting a platform to address the rally, AFGE President David Cox Sr. shouted: *"We're trying like hell to stop it."* Then, looking at the crowd dressed in union colours, Cox noted the green and blue and yelled: *"Congress is looking at red. They want our blood."* In a statement from Rep. Steny Hoyer, the House's second ranking Democrat and whose Maryland district is home to thousands of federal employees, he raged: *"Here we are once again on the brink of a fiscal meltdown. It's a game that has no winners, only losers, like the 14,000 teachers, assistants and other education staff who would lose their jobs, or the 125,000 families who would be at risk of losing their homes when our rental assistance program is cut, or the thousands of civilian defense personnel in my district alone and throughout this country who would be furloughed for up to 22 days during the year and the hundreds of thousands around the country , across every service branch; not to mention the tens of thousands of defense contractors, critical to our national security, who would be at risk of losing their jobs."*

Trent Berhow, a U.S. Agriculture Department consumer safety inspector and an AFGE officer in St. Joseph, Missouri, told the crowd: *"The planned cutbacks would mean lost wages, consumers would experience limited meat, poultry and egg product supplies, higher prices and food safety would be compromised. The sequestration is horrible policy. I am here today with you, my brothers and sisters, to send a message to Congress: End this sequestration madness now!"* Food inspections demonstrate how a sequester could affect consumers and workers beyond the federal work force. The USDA says the budget cuts could mean unpaid leave for up to 15 days for Food Safety and Inspection Service employees, including inspectors. Without inspectors, production of meat, poultry and egg products would have to shut down. The USDA says that would affect about 6,290 facilities nationally, resulting in more than $10 billion (U.S.) in production losses and $400 million (U.S.) in lost wages for industry workers. As the sequester – which would lead to payless days for federal workers – is being debated, so is legislation that would extend the freeze on their basic pay rates through the end of 2013. A vote on the bill, sponsored by a group of House Republicans, is planned for this week. The freeze is scheduled to end in March. Obama has called for workers' pay to increase by 0.5% at that time and by 1% starting in 2014. In a statement, Colleen Kelley, President of the National Treasury Employees Union declared: *"Despite what supporters of this proposal may say about respecting the work of federal employees, blocking a modest pay raise of 0.5% for dedicated public servants who are working under a 27-month pay freeze sends quite the opposite message – that neither they nor their wok are viewed as important to our nation."*

Union leaders address protesting federal workers. Source: The Washington Post



As the U.S. national debt level inexorably climbs its way toward the $17 trillion (U.S.) mark (see chart above), at Longwave Analytics we would remind our readers that we expect this self-inflicted American indebtedness will never be repaid. Indeed, after only four months into its 2013 fiscal year, the U.S. government remains on a path to add another $871.26 billion (U.S.) to its national debt level by September 30th. When we recall the hypothesis of a person – commencing at the time of the birth of Jesus – spending $1 million a day for the past 2,000 plus years and still not reaching one trillion dollars, one can only react in utter awe to the universal magnitude of such a debt burden.

The Explosion of Global Credit

As has been the case since the end of the U.S. Civil War in 1865 to the present day, credit is the power which fuels the functionality of the global economy. Whether it be consumers purchasing items at a local shopping mall using credit cards, national governments issuing sovereign debt in the world's fixed income markets, a Canadian bank issuing 50-year bonds to institutional buyers in the bond market, troubled countries in the euro zone borrowing bailout money from the European Central Bank, corporations and municipalities in America issuing bonds over a wide spectrum of maturity dates, or investors purchasing equities in the world's stock markets on margin; the global economy functions as a result of an enormous reliance upon the use of credit. Never before in the history of global commerce has the world been so awash in debt, or on so many levels.

Indeed, according to the Financial Times, a brisk trade in emerging market bonds has triggered fears that an emerging market debt bubble is inflating. Never before has the developing world enjoyed such low bond yields, at least in U.S. dollars. The risk is that some emerging economies and their companies may be borrowing too much money denominated in foreign currencies. According to Dealogic, the volume of foreign currency bonds issued by emerging market companies and banks broke records in 2012, totaling more than $300 billion (U.S.). The pace of issuance to date in 2013 is almost twice that of last year.

The Developing Currency Wars

"As purported by Le Metropole Café, for about the past decade, "competitive devaluation" has been the official monetary policy of many governments: competing to see who could destroy the value of their currency the fastest. So, how would a "currency war" differ from our present "competitive devaluation?" At most, a currency war would simply be a greater degree of what corrupt governments have already been doing for the past ten years. At the least, the difference is pure semantics. Thus, when anyone speaks of the U.S. government's efforts to "calm" concern about a currency war, the sham is utterly transparent. Our dishonest governments are attempting to reassure us that they aren't "planning" on doing the same thing they have been doing for the past decade. This is much like a heroin addict reassuring anyone who will listen, that he has "no plans" to shoot-up with more heroin. This leads us to two closely related questions. Why are our governments lying about their currency destruction? Why is the success of this lie of such vital importance to these governments? The answer to these questions requires an equal amount of arithmetic (calculation) and an understanding of human nature.

One thing that humanity has always excelled at is destroying things. Thus, when our governments "compete" to destroy their own currencies, we know they will be successful. From the moment that competitive devaluation began, the only possible outcome was all these debauched currencies going to zero, i.e. the definition of hyperinflation. However, even our dim-witted political servants can comprehend the inevitable result of competitive devaluation: all their paper currencies utterly worthless and the fraudulent paper empires of their oligarch masters nothing but confetti. The only way to delay this outcome is to lie about what they are doing and manipulate markets to hide the effects of their actions. Hyperinflation should be an event of pure mathematics, since exponentially increasing money printing (i.e. currency dilution) should produce identical, but inverse curves. One curve shows the money printing going to infinity, while its mirror image shows the value of the currency going to zero at the same rate. However, hundreds of years of empirical evidence show us that the typical hyperinflation is not an arithmetic event, but rather a "crisis of confidence."

Logic tells us that hyperinflations should be events of pure arithmetic. History tells us that most hyperinflations are a "crisis of confidence." That is to say, the "final stage" of most hyperinflations is the interval between when a currency actually becomes worthless and the citizens realize that the paper is worthless, i.e. the moment the governments – and the bankers lurking behind them – lose the trust of the citizenry. Effectively, our paper currencies are already worthless. This can be demonstrated unequivocally in several different ways. Permanent near zero interest rates alone make these paper currencies virtually worthless. However, most of this Western paper is worthless on a much more fundamental basis. Arguably, none of this paper has retained any value since the Nixon regime abolished the quasi-gold standard (in 1971) which “backed” the U.S. dollar. Since that time, any “value” in this paper has been purely implied; almost identical to how a share in a corporation derives value. We understand that if we hold shares in a bankrupt company, those shares are likely worthless.

Most Western governments are now obviously and utterly insolvent. The near complete monetization of debt in both the U.S. and Europe is unequivocal mathematical proof of this point. To illustrate this, we must understand why the U.S. government and the European Monetary Union have chosen to engage in almost the complete monetization of debt. It’s not that there are “no buyers” for this debt in absolute terms. Rather there are no buyers for any of these fraud bonds at their fantasy yield levels – many, many basis points below any rational yield on the debts of these deadbeat debtors. Obviously, with all Western governments less solvent than at any time in the history of credit markets, interest rates should reflect that much higher level of risk; especially, with one of those deadbeat debtors (Greece) having already defaulted.

Pull out your calculator and you will see that if the United States was forced to pay a10% interest rate on its massive bond issues, it would be bankrupt today. Likewise, if Europe’s deadbeat debtors were forced to pay 10% interest on their massive debts, most of them would be bankrupt today. That rate would still only be half as high that interest rates rose in the Volcker era; to “cure” precisely the same spiraling inflation we have today. Thus, the U.S. and European governments are currently monetizing their own debt in order to (fraudulently) drive down interest rates on their own bad debts; as literally the last ditch effort to ward off immediate bankruptcy. Obviously, the only thing preventing the immediate bankruptcy of these “corporations” is through fraudulently manipulating the coupon rates on their debt far below any rational market value. History also tells us that a final “crisis of confidence” which occurs when these paper currencies die, is more often than not lightning-quick. You go to sleep one night with “money” in your wallet and you awake in the morning with a pocket full of confetti.”

At Longwave Analytics, we have oftimes referred our readers to the competitive currency devaluation wars which were very apparent in the 1930s, when all countries were attempting to devalue in order to improve their positions in international trade, which had ground to a halt as a result of the Great Depression.

The Impending Implosion of Global Credit

At Longwave Analytics, when we bear witness to the stimulus packages being undertaken in Japan, the European Union, China and the emerging markets of Southeast Asia, we must conclude that the world is fervently travelling down the road to credit destruction. We believe there could be a temporary period of hyperinflation following the bursting of the current credit bubble, when gasoline and foodstuffs will be unobtainable at any price. However, it will be soon followed by a protracted deflationary period as excessive debt is expunged from the global economy and countries experience a severe contraction in their respective gross domestic products.

When in concert to the above, we add the limitless central bank quantitative easing policies of the U.S. Federal Reserve, the Bank of England, the Bank of Japan and the not to be outdone European Central Bank, we can only foresee that such an enormous amount of printing of fiat money can only produce an unhappy result. Rather, at this 80th. anniversary date of the height of the Great Depression, what we are witnessing is the beginning of the end of paper money as we know it. Within such an economic downward spiral, an investor’s only protection is embedded in precious metals, principally gold, much as it was in the 1930s.

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