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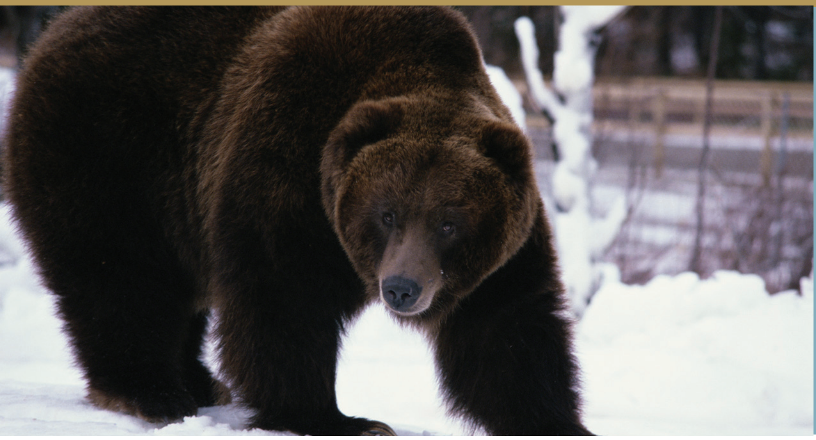
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

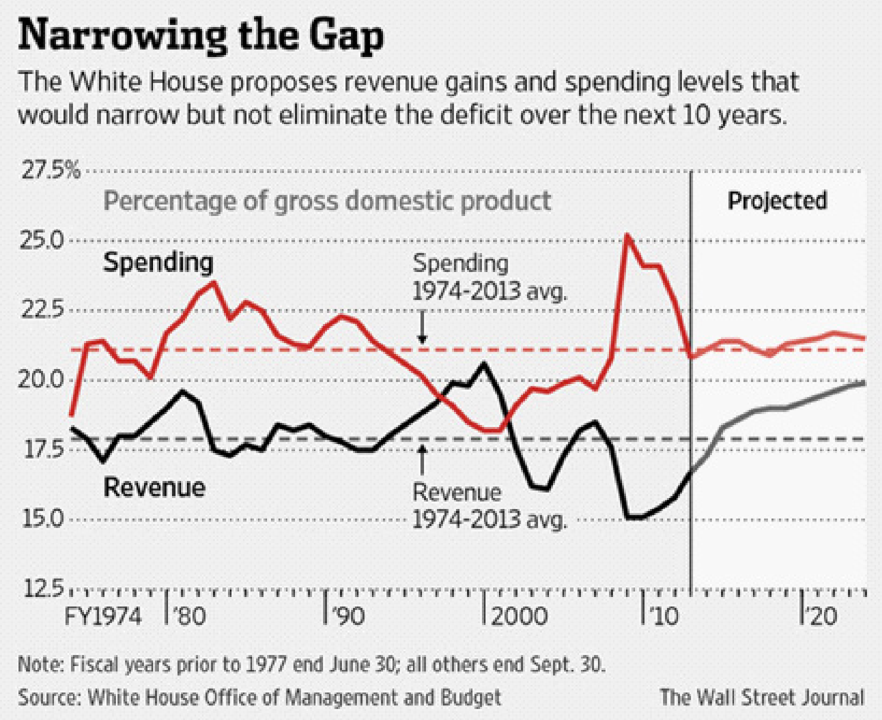
ECONOMIC WINTER

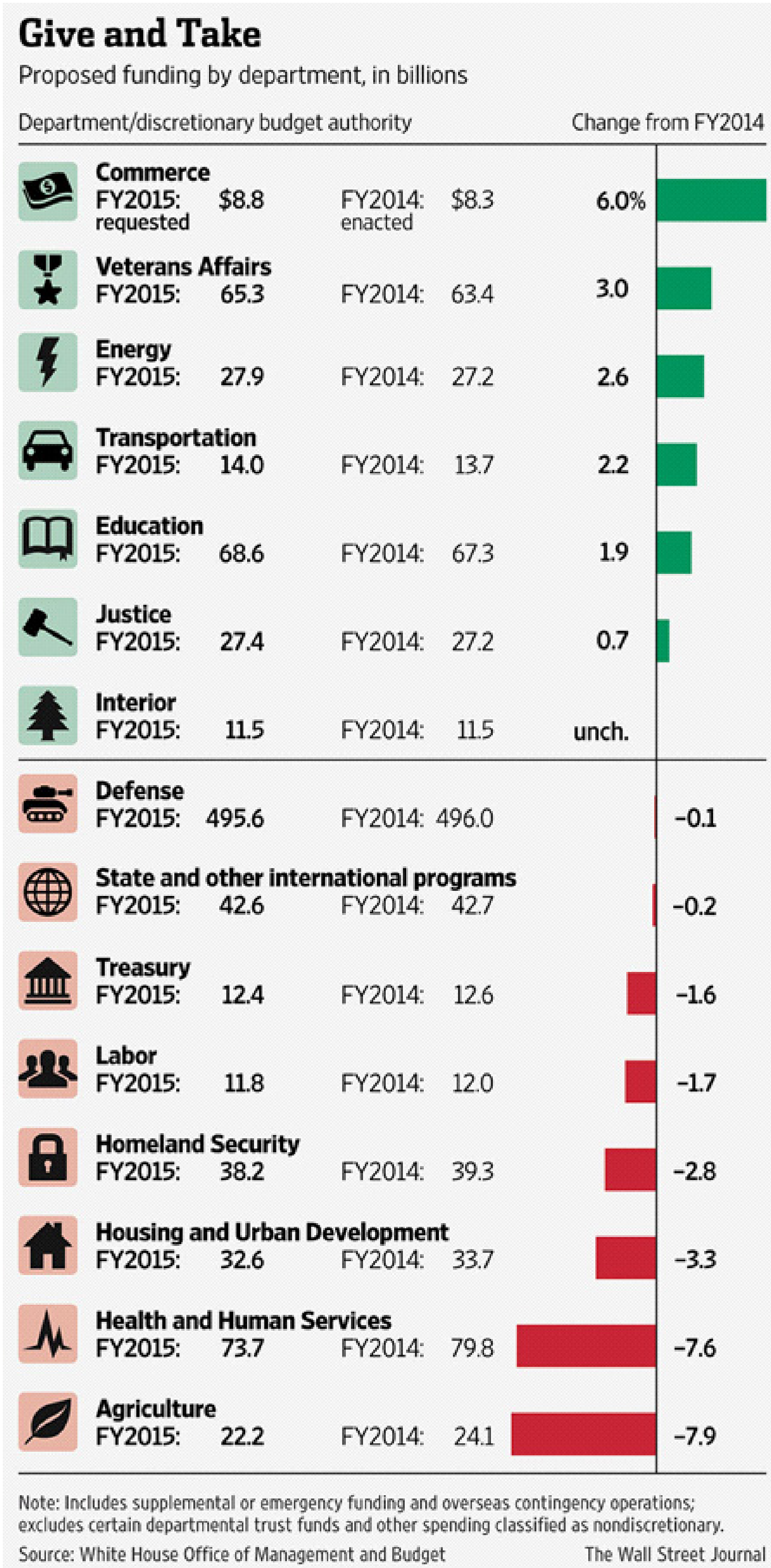


It's Still the Debt, Stupid

Introduction – President Obama Heralds End to Austerity in 2015 Budget

With his $3.9 trillion (U.S.) budget request for fiscal 2015 – as documented in the Washington Post on March 4th. – U.S. President Obama is calling for an end of the era of austerity that has haunted much of his presidency and limited his efforts to find common financial ground with Republicans. Rather, the President is focusing on pumping new cash into job training, early-childhood education and other programs aimed at bolstering the middle class; thereby, providing Democrats with a budget policy blueprint heading into the November mid-term elections. Comprising part of that strategy has President Obama jettisoning the framework he unveiled last year for a so-termed 'grand bargain' that would have raised taxes on the rich and reduced skyrocketing retirement spending. Nevertheless, the budget projects a fiscal deficit of $564 billion (U.S.) which represents 3.1% of the nation's gross domestic product (GDP).



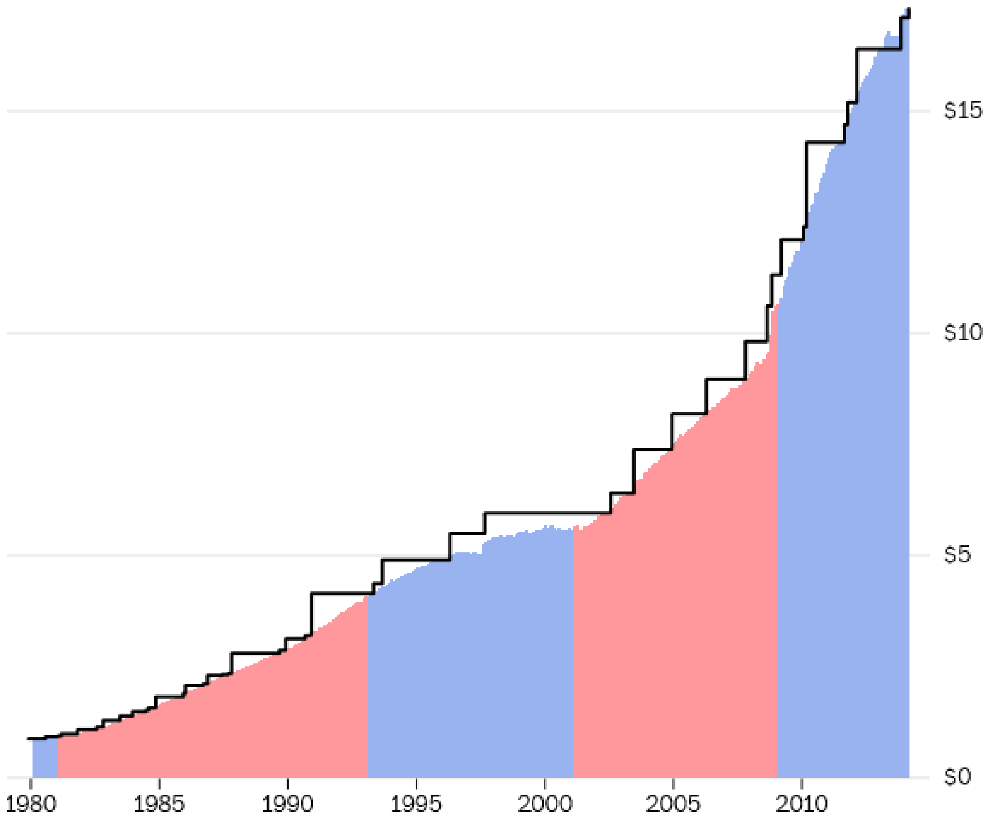

Give and Take
Proposed funding by department, in billions
Department/discretionary budget authority
Change from FY2014
Commerce
FY2015: requested $8.8
FY2014: enacted $8.3
6.0%
Veterans Affairs
FY2015: 65.3
FY2014: 63.4
3.0
Energy
FY2015: 27.9
FY2014: 27.2
2.6
Transportation
FY2015: 14.0
FY2014: 13.7
2.2
Education
FY2015: 68.6
FY2014: 67.3
1.9
Justice
FY2015: 27.4
FY2014: 27.2
0.7
Interior
FY2015: 11.5
FY2014: 11.5
unch.
Defense
FY2015: 495.6
FY2014: 496.0
−0.1
State and other international programs
FY2015: 42.6
FY2014: 42.7
−0.2
Treasury
FY2015: 12.4
FY2014: 12.6
−1.6
Labor
FY2015: 11.8
FY2014: 12.0
−1.7
Homeland Security
FY2015: 38.2
FY2014: 39.3
−2.8
Housing and Urban Development
FY2015: 32.6
FY2014: 33.7
−3.3
Health and Human Services
FY2015: 73.7
FY2014: 79.8
−7.6
Agriculture
FY2015: 22.2
FY2014: 24.1
−7.9
Note: Includes supplemental or emergency funding and overseas contingency operations; excludes certain departmental trust funds and other spending classified as nondiscretionary.
Source: White House Office of Management and Budget
The Wall Street Journal

President Obama's Budget Seeks Overhaul of Business Tax Codes

The above chart – sourced from the White House Office of Management and Budget – outlines a breakdown of the major components of President Obama's proposed budget for the fiscal year ending September 30, 2015. The President has proposed his biggest tax increases yet on multinational corporations' overseas earnings -- $276 billion (U.S.) that companies would have to pay over the next decade – largely through changes designed to prevent corporations from stashing profits offshore. Administration officials noted the tax changes would be paired with a separate reduction in corporate tax rates that would be included in a broad tax overhaul that President Obama hopes to move through Congress. Moreover, President Obama's budget opens the door to the possibility of raising taxes on businesses to fund infrastructure. It earmarks $150 billion (U.S.) of one-time revenues from a tax overhaul for shoring up the nation's increasingly shaky highway funding system. The budget doesn't specify exactly where that money would be sourced within the business tax system, however much of the administration's new revenue would be derived from its increases on multinational's international operations. Multinationals – particularly high-tech and some pharmaceutical firms – have been criticized in recent years for using complex tax manoeuvers to stash more of their revenue in offshore tax havens. President Obama's budget proposes a number of methods to discourage such so-termed 'base erosion.' A U.S Treasury Department spokesperson – requesting anonymity – recently stated: "The international tax proposals are part of our reserve for business tax reform in the context of overall tax reform that would lower tax rates and enhance the competitiveness of American businesses."

CBO Projects Exponential Increase in U.S. National Debt

According to a new Congressional Budget Office report released on February 4th. the bipartisan agency is projecting U.S. federal deficits to escalate again over the next decade, as a result of rising health care costs and increasing interest payments to service outstanding issues of U.S. Treasury notes and bonds. The CBO report forecasts the deficit will exceed $1 trillion (U.S.) again in 2022 and reach $1.074 trillion (U.S.) or 4% of gross domestic product in 2024; at which time publically held debt will reach $21.3 trillion (U.S.), or 79.2% of GDP; up from $12.7 trillion (U.S.), or 73.6% of GDP this year.



Sources: Congressional Budget Office, U.S. Department of the Treasury

The above chart depicts the American national debt's inexorable climb to its current level of $17.4 trillion (U.S.). Shaded areas in red indicate a Republican controlled Congress, while blue areas indicate a Democratic controlled Congress. Were President Obama's proposed budget to be adopted with little change, at Longwave Analytics, we can foresee that by September 30, 2015, America's national debt could likely **exceed $18 trillion (U.S.) i.e. $18,000,000,000,000**. In the meantime, Congress has displayed the mindless alacrity of suspending the statutory debt limit until March 15, 2015. **Beware of the Ides of March, 2015!**

The Financial Causes of the Government Debt Trap

In his book, A Nation In The Red – The U.S. Government Debt Crisis, McGraw Hill 2014, author Murray Holland writes: 'There is no doubt that when members of the press cover the collapsing economies around the world and the serious debt problems the United States is facing today, they are referring to the symptom of governments running out of money, spending too much on interest expense, being unable to find investors to lend them any more money and so on. Such is the level of understanding of most pundits and no doubt they are correct in their assessment that this is the problem facing all governments which have entered the Debt Trap. Interestingly, all these governments have entered the same trap by different ways. It has not been only a war that has drained the coffers; it has been banking failures (in the case of Cyprus and Ireland), economic failures (in Spain), too much government borrowing in the past (in Japan and Italy) and too much social spending (in southern Europe, Argentina and elsewhere). All these reasons have no effect on the fixed income market because the bond market only cares about risk and return. It does not care why you borrowed the money and why you are in the Debt Trap, it just wants you to pay it back. Until you do, it will charge you interest which reflects the risk it perceives in your ability to repay the loans. Individuals and businesses may borrow too much money and go bust: this happens every day. It is part of life and the downside is the people and organizations involved are devastated. However, their failure does not drag down and defeat an entire nation. When a national government goes bust, it does drag down the entire nation with it. That nation is defeated and is brought down because of its government: it borrowed too much money. Why do governments get into the borrowing game anyhow? To anyone who has ever borrowed money to purchase a car, a house or a business, it is a relatively easy thing to do. Paying it back is the difficult part. It increases the risk of a financial failure for you and your family. If you never borrow money, you cannot fail, or at least not spectacularly. The same is true with government debt. It is difficult to repay. The government must use money it would otherwise have for other services. The downside to government debt is a failure of the government and the entire economy. This is the problem with government debt that is not present with personal and business debt. The government is risking the entire economy and devastation of millions of lives if it fails, so why would it take that risk?

In the past, governments have borrowed to finance wars, which on its face seems to be a valid reason to borrow money even with the risk of financial devastation. Had the United States not borrowed money to enter World War II, the world would be a different place today. I believe almost all Americans supported borrowing money for that war even if there was a substantial risk of dragging the country into the Debt Trap. I don't believe there was that kind of support for any of the other wars in which the country has participated. Since World War II, governments have also borrowed money to support their banks during banking crises; but mainly governments have borrowed to support social programs. In the last ten years, many governments which have defaulted on their national debt and are now in the grip of the Debt Trap, have done so to provide social benefits to a group of recipients who were lucky enough to be recipients during the 2000 – 2010 period. Social program recipients before that time did not receive the benefit of all this borrowing and recipients after 2010, will not receive these benefits because these countries can no longer borrow and must live within a balanced budget.

The lucky recipients of cash from the government during the last decade will be the only recipients of government largesse from borrowed money. Until the last decade, the United States operated on a pay-as-you-go basis, more or less and over the last decade the government borrowed up to its borrowing capacity. (I believe it far exceeded a safe borrowing capacity.) Americans will not have that borrowing capability in the future and the people who were the cash recipients in the last decade were lucky to be there when they were. In the future, no one will be that lucky. For the next one hundred years, if America can survive the Debt Trap, taxpayers will be paying interest on debt incurred by the government to distribute to the lucky few who were in line to receive cash over this short period of time. Is this a valid use of the country's borrowing capacity?

Global Debt Exceeds $100 Trillion (U.S.)

In its most recent quarterly review, the Basel, Switzerland-based Bank for International Settlements reports: “Total global debt has increased from $70 trillion (U.S.) in 2007 to $100 trillion (U.S.) by mid-2013. Given the significant expansion in government spending over recent years, all forms of government – federal, state and local – have been the largest debt issuers.”

The Headquarters of the Bank for International Settlements in Basel. Source: Bloomberg

The U.K. Government Debt Iceberg

According to a new report released by London’s Institute of Economic Affairs (IEA) and published in the Daily Telegraph, Britain faces crippling tax increases and spending cuts if it is to fund the pension costs and meet the healthcare needs of its aging population. The IEA report’s author Jagadeesh Gokhale calculated the Government would have to cut spending by more than 25%, or impose significant tax increases because official calculations had failed to factor in future pension and healthcare liabilities: “As populations age, tax bases will grow more slowly while Government spending increases faster.” In a stark warning, the IEA asserted that Britain faces tax increases within just two years equivalent to more than 17% of GDP – in excess of 300 billion pounds – in order to meet all future spending commitments. This is larger than the entire annual National Health Services (NHS) budget and would increase taxes from 38% to 55% of national income. Philip Booth, the IEA’s Program Director stated: “Tax increases of this magnitude would be impossible to implement without choking off economic growth and actually reducing tax revenues. The underlying problem is that successive governments have made promises which simply cannot be honoured from the existing tax base. The electorate is grazing a fiscal commons at the expense of future generations. We have never been in a situation like this before. It is quite possible that we will not find our way through without serious social breakdown and/or mass immigration of the most mobile and productive people. Without reform, today’s young people are likely to be disappointed, either in terms of higher tax rates, or in terms of reduced future benefits provided by Government. The quicker the Government changes policy, the more painlessly the situation will be resolved. For too long, people have voted themselves benefits to be paid for by the next generation of taxpayers, not by sacrifices that they will make themselves.”

The IEA report warned that without significant changes to spending levels, huge sacrifices will have to be endured by future generations, either via significantly higher taxes, or reduced benefits. The IEA calculated that delaying crucial pension and healthcare reforms by just a few years would dramatically increase the burden because of growing debt servicing costs. It said the ratio would increase from 13.7% of GDP in 2010 – already higher than the European Union (EU) average of 13.5% -- to almost 17.1% by 2016, if no policy adjustments were made. The report also warned that governments would not be able to grow their way out of trouble and were often too focused on short term GDP growth. While the Government's decision to move assets of the Royal Mail Pension Fund had reduced short-term debt obligations, long-term state pension liabilities had increased. The Government took the assets of the Royal Mail Pension Fund and gave the workers promises of Government pensions in return. The explicit Government debt was reduced, but future Government liabilities – in this case contractual – were increased.

Down and Out: The French Flee a Nation in Despair

As noted recently by Moneytalks, a poll published on the front page of France's Le Monde in early March revealed: 'More than 70% of the French feel that taxes are excessive and 80% believe President Hollande's economic policy is misguided and inefficient.' This goes far beyond the tax exiles Gerard Depardieu, members of the Peugeot family or Chanel's owners. Worse, after decades of living in one of the most redistributive systems in Western Europe, 54% of the French believe that taxes – of which there have been 87 new ones in the past two years, increasing from 42% of gross domestic product (GDP) in 2009 to 46.3% this year – now widen social inequalities instead of reducing them. This is a noteworthy departure, in a country where the much-vaunted value of equality has historically been tinged with envy and resentment of the more fortunate. Less than two years ago, the most toxic accusation levied at Nicolas Sarkozy was of being 'le president des riches,' favouring his yacht-sailing CEO buddies with tax breaks and sweet deals. By contrast, Hollande, the bling-free candidate, was elected on a platform of increasing state spending by promising to create 60,000 teachers' jobs; as well as 150,000 subsidized entry-level public service jobs for the long-time unemployed and the young – without providing for significant savings elsewhere.

The Spectre of Euro Zone Deflation

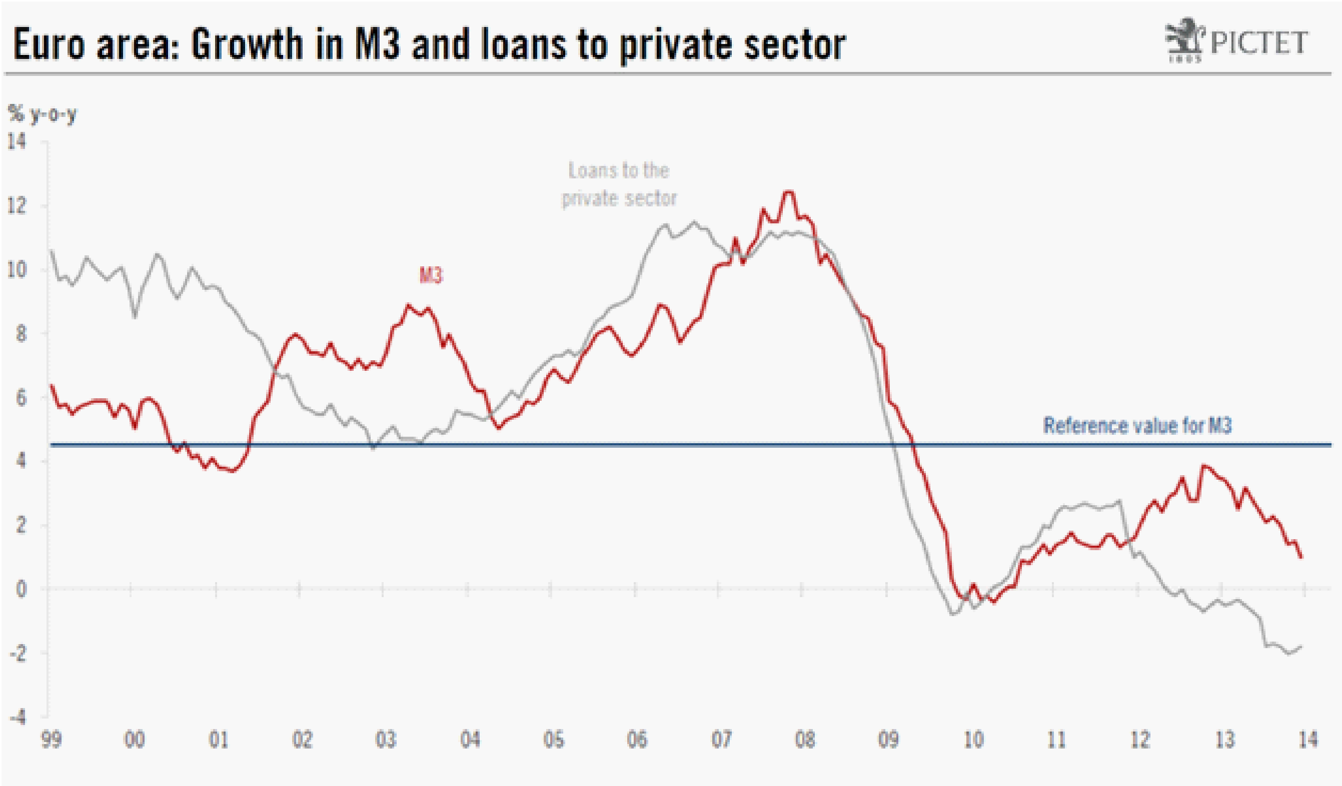
As recently chronicled in the Financial Times, reporter Martin Wolf writes: The European Central Bank is failing to hit its own target for price stability. The difficulty is that the ECB's governing council may be unable to agree on effective measures, largely because of disagreements along national lines. That might prove very dangerous … True its target is neither as unambiguous, nor as symmetrical as the ones adopted by other central banks. The ECB's aim is to achieve inflation 'below, but close to, 2% over the medium term.' Yet in the year to February 2014, headline inflation was 0.8%. This is hardly close to 2%. It is also highly dangerous, as is cogently argued in a blog by senior members of the IMF's European Department.

Firstly, this low inflation rate, as is to be expected, coincided with weak demand. In the 4th. quarter of 2013, euro zone real demand was 5% below the levels in the 1st. quarter of 2008. In Spain, real demand fell by16% and in Italy it fell by 12%. Even in Germany, real demand stagnated from the 2nd. quarter of 2011: this is no locomotive. The failure to offset this has made the recovery of crisis-hit economies more difficult, lowered investment and created long-term unemployment. All this will deeply scar the euro zone.

Secondly, there is an appreciable risk that the euro zone will fall into deflation. ECB President Draghi has described deflation as a situation where price level declines occur across a significant number of countries, across a significant number of goods and in a self-fulfilling way. By this definition, deflation is absent: only three countries have negative inflation and only a fifth of items in the consumer price index (CPI) have declined in price. Longer term inflation expectations are also stable at close to 2%, although short-term expectations have fallen. As the IMF authors argue: 'One should not take too much comfort in the fact that long-term inflation expectations are positive.' The data indicate that, over the long term, euro zone prices are expected to increase at a healthy 2% per year. However, as they point out, long-term inflation expectations were also reassuringly positive immediately before three bouts of deflation in Japan. It was nearer expectations that turned more pessimistic, leading to declines in prices and wages which enabled deflation to take hold. Simply put, the euro zone is just one negative shock away from deflation … When negative short-term real interest rates are needed in order to avoid deflation, the situation becomes perilous.

A Paralyzed ECB Leaves Europe at the Mercy of Deflation Shock from China

As recently editorialized in the Daily Telegraph, International Business Editor Ambrose Evans-Pritchard waxes prolific: Most of western Europe is already in outright deflation. So are the Balkans, the Baltic states and the old Hapsburg core. The Continent has left its flank open to an external shock from Asia. There is a high chance that this will occur as China attempts to extricate itself from a $24 trillion (U.S.) credit misadventure by debasing its currency to regain lost competitiveness and bail out its export industry. The yuan has fallen by nearly 2% against the U.S. dollar since early January and by 4% against the euro. For all the talk of weaning China off chronic over-investment, Beijing engineered a record $5 trillion (U.S.) of investment in fixed capital last year – up 20% from 2012 – and as much as the U.S. and Europe combined. This has created a vast overhang of excess manufacturing capacity in the global system. It is coming our way in the form of a slow, powerful, deflationary undercurrent. Europe's headline price data understate the full deflation risk. Eurostat's HICP index 'at constant taxes' – minus the one-off effects of austerity – shows that 23 of the EU's 28 countries have seen a decline in prices over the past seven months. IMF Chief Economist Olivier Blanchard recently noted: 'The risk of deflation is definitely before us.'



By this measure, inflation since June 2013 has been running at a rate of minus 1% in France, minus 2% in Holland, Belgium and Slovenia, minus 4% in Italy, Spain and Portugal, minus 6% in Greece and minus 10% in Cyprus. Sweden and Switzerland are also in deflation. Germany rolled over last July. The U.K. still clings to a little inflation – now a precious commodity – but it too turned negative in September. This is a nightmare for the debt-stricken states of southern Europe, still trapped in an economic slump with mass unemployment, regardless of whether they manage to eke out the odd quarter of miserable GDP growth. With Germany at zero inflation, they have to go into even deeper deflation in order to claw back lost competitiveness within the European Monetary Union (EMU) under 'internal devaluations.' This, in turn, wreaks havoc with debt dynamics through the denominator effect. Their debt loads are rising on a base of flat or contracting GDP. It is a key reason why Italy's public debt has increased from 119% to 133% of GDP since 2010, despite achieving a primary budget surplus, or why Portugal's debt soared from 94% to 129% of GDP, according to IMF data. These countries have an impossible task, damned if they do and damned if they don't. Mr. Blanchard has remarked that their gains in competitiveness risk being overwhelmed by an increase in the 'real value' of their debt. The danger is that the second effect dominates the first, leading to lower output and further deflation. Of course, there is no magic line when inflation falls below zero. A recent IMF study concluded the effects become lethal for economies with high public/private debt loads, mostly over 300% of GDP in the Mediterranean periphery.

The European Central Bank (ECB) is betting that this plunge in prices is a temporary blip due to lower energy costs, insisting that inflation expectations remain firmly anchored. The collapse of iron ore and copper prices over recent times – on China nervousness – should puncture these illusions. In any case, the ECB's expectations doctrine is a Maginot Line.

The IMF has previously stated: 'Long-term inflation expectations on the eve of three deflationary episodes in Japan were also reassuringly positive … One needs to act forcefully before deflation sets in because Japan was too slow to lower interest rates and boost the monetary base. In that circumstance, it had to resort to ever-increasing stimulus measures once deflation took hold. Two decades later, that effort remains ongoing.' As late as January, 1998 Bank of Japan Governor Yasuo Matsushita declared: 'There is no reason to expect that overall prices will drop sharply and exert deflationary pressure on the entire economy.' As a result of this lordly certitude, Japan suffered shattering effects when the East Asia crisis entered its second and more deadly phase that summer.

The ECB's Mario Draghi risks going down in history as Europe's Mr. Matsushita, as he continues to insist that EMU inflation today is merely where it was in 2009 – during the post-Lehman mayhem – and therefore benign and that Euroland is not remotely like Japan. Mr. Draghi has stated: 'The ECB has taken decisive action at a very early stage of this crisis.' The proof is in the monetary pudding and this shows that the EMU is already in worse shape than Japan in early 1998 by a large margin. Private lending is contracting at a rate of 2.3%, the M3 money supply has ground to a halt and EMU-wide unemployment is stuck at a near-record 12%.

By definition, the ECB is ferociously tight. Marcel Fratzscher, director of the Berlin-based German Institute for Economic Research (DIW) is right to berate the ECB for betraying its primary duty and demanding 60 billion euros of bond purchases each month before it is too late: 'It is high time for the ECB to act, otherwise, Europe risks falling into a dangerous downward spiral.' In addition, Euro Intelligence has stated: 'Failure to act would be an existential disaster for the euro zone and a shocking derogation of the ECB's mandate.'

Mr. Draghi has bent over backwards to assuage the hard-money monks at the Bundesbank … His task has become even more complicated since the German Constitutional Court ruled last month in thunderous language that the ECB's bond rescue plan for Italy and Spain 'exceeds the ECB's monetary policy mandate, infringes upon the powers of the Member States and violates the prohibition of monetary financing of the budget.' The Court also ruled the ECB's Outright Monetary Transaction (OMT) plan was probably 'Ultra Vires' , meaning that the German Bundesbank may not participate. While the Court ruling is not final – and does not prohibit ECB bond purchases as such – it raises the bar for quantitative easing to a punishingly high level. While the U.S. Federal Reserve and the Bank of England were able to act instantly, once it became clear that QE on a huge scale was imperative, the ECB is paralyzed by politics, ideology and judges. There have been dovish mutterings from ECB members over recent days, but any action is likely to be confined for now to token gestures, such as a negative deposit rate or easier collateral rules for banks, not the one trillion euro blastoff QE that is so obviously needed immediately. The increase in the euro to 1.39 against the U.S. dollar tells us that the markets expect nothing of substance.

Europe is left at the mercy of world events. The Federal Reserve is pressing ahead with $10 billion (U.S.) of tapering at each meeting, slowly forcing up global bond yields and tightening the vice further for emerging markets. The ECB has ignored the pleas for mercy from the developing world – still addicted to dollar liquidity – just as it did in the months before the Asian crisis of 1998. This week, the OECD warned that the real impact of Fed tapering has 'only just begun' and the effects threaten to ricochet back into Europe through trade and banking stress in emerging markets. China is tightening as well in what amounts to a monetary squeeze. It has been so successful that shadow banking virtually froze in February; prompting the Bank of China to step back in consternation by its own handiwork … China will not collapse because the banking system is an arm of the state, but it will have to cope with the colossal malinvestments left from a hubristic five-year blow-off. Deflation is already stalking the country, as factory gate inflation has already dropped to minus 2%. We can be certain that China will seek to pass this deflationary parcel to somebody else, just as the Japanese have already done with their epic devaluation under Abenomics. The package will likely land in Europe, which is the one region that lacks a proper central bank and the governing coherence to protect its own interests. The implications for the depression-wracked societies of the Mediterranean are nothing less than calamitous."

Summary and Outlook

Despite having the world's largest economy, as well as the world's reserve currency, the United States of America is clearly fashioning a death wish of exponential domestic debt, the likes of which has never been witnessed before. With the U.S. national debt now totaling $17.4 trillion ($17,400,000,000,000), this figure could easily grow to $18 trillion by the fiscal year ending September 30, 2015 and to $20 trillion by the fiscal year end 2020. America's President Barack Obama has already proposed a budget for fiscal 2015, projecting a deficit of $564 billion, which has been largely ignored by both the media and the financial markets. Indeed, there seems to be a broadly held belief that America can expand its economy to a much higher sustainable level than exists at present and thereby, eventually grow its way out of debt. **Let the word go forth from Longwave Analytics: we believe that a snowman stands a better chance of survival in Hades, than the U.S. has of growing its economy and being extricated from its gargantuan national debt dilemma**. Similarly, several countries in the European Monetary Union, notably Italy, Greece, Portugal, France and Spain are burdened with substantial debt loads and high levels of unemployment, with little prospect of their economies doing anything but treading water for the foreseeable future. Even Great Britain faces staggering tax hikes and spending cuts to fund pension costs.

The main reason why we have not witnessed the global economy sink into depression is due to the resistance being waged by the U.S. Federal Reserve through its quantitative easing program. However, it would now appear that monetary policy measure may be coming to an end. When it does, the Fed will still have over $4 trillion of U.S. Treasurys and mortgage-backed securities on its balance sheet. Our guesstimate is that the Fed will not sell these holdings gradually into the open market, rather it will mature them at their respective due dates. However, this strategy necessitates the U.S. Department of the Treasury be in possession of sufficient funds to redeem the bonds on their respective maturity dates. Moreover, trillions of dollars of unregulated derivative securities still haunt thousands of investment portfolios.

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Over 80 years have now elapsed since the beginning of the Great Depression of the 1930's, during which time thousands of U.S. banks failed. Likewise, during the present time of the Kondratieff winter season, debt must be expunged from the global economy in order for the next expansion cycle to unfold.

Written By: Christopher Funston