

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE  
**THAT WAS THE WEEK THAT WAS**



Monday, December 27th

According to a report from the Empire Center for New York State Policy, “public pension costs in New York are mushrooming – just when taxpayers can least afford it.”

MONDAY, DECEMBER 27TH

Over the next five years, tax-funded annual contributions to the New York State Teachers' Retirement System (NYSTRS) will more than quadruple, while contributions to the New York State and Local Retirement System (NYSLRS) will more than double. New York City's budgeted pension costs, which have already increased tenfold over the past decade, will increase by at least twenty per cent more in the next three years, according to the City's financial plan projections.

- Japan's government unveils a budget for the balance of the current fiscal year ending March 31, 2011 that sets a course for gross state debt to exceed 200% of gross domestic product (GDP) and for new bond issuance to surpass tax revenues for the third consecutive year. Last week, the Japanese cabinet met its target to cap new debt issuance just below the \$535 billion (U.S.) projected for this fiscal year. While Japan faces growing debt levels, it has little difficulty in funding its deficit, with interest rates remaining low and demand for government bonds still robust. However, it is unknown how long such investor confidence can last, given the government's chronic failure to narrow the budget gap between revenues and expenditures.
- An investigation by the New York Times reveals that despite sanctions and trade embargoes, the United States Government has permitted American companies to transact billions of dollars in business with Iran and other countries blacklisted as state sponsors of terrorism. At the behest of an host of companies – from Kraft Foods and Pepsi to some of the nation's largest banks, a little known office of the U.S. Treasury Department

has granted nearly 10,000 licenses for business deals involving countries which have been cast into economic purgatory, beyond the normal reach of American business. Perhaps, this is why the Obama administration sees no problem in encouraging Russia to become a member of the World Trade Organization (WTO).

TUESDAY, DECEMBER 28TH

- The Conference Board reports its U.S. consumer confidence index declined to a reading of 52.5 in December, from a level of 54.1 in November. Lynne Franco, the Conference Board's director of the consumer research center commented: “Consumers' assessment of the current state of the economy and labor market remains tepid and their outlook remains cautious. Signs suggest a continuation of the economy's expansion next year, but the pace of growth will remain moderate.”
- S&P / Case-Shiller reports its 20-city index of U.S. property values fell by 0.8% in October from October 2009, the biggest year-over-year decline since December 2008. Dean Maki, chief economist at Barclay's Capital, New York, commented: “We'll remain in negative territory for several more months. The housing market does remain weak and none of the recent data suggest a substantial pickup.”

- The Paris-based statistics office Insee reports France's gross domestic product (GDP) grew by 0.3% in the 3rd. quarter compared with a 0.6% gain in the previous quarter. Joost Beaumont, an economist at ABN Amro Bank in Amsterdam, comments: "Consumer final demand was the engine for growth in the 3rd. quarter and I think the positive impact from it is likely to become less in the coming quarters amid fiscal retrenchment and quite weak labour market conditions."
- The City of Hamtramck, Michigan pleads with the State to allow it to declare bankruptcy, as the City's budget expenditures have been cut to the bone and property tax revenues remain anemic. City Manager Bill Cooper outlined the municipality's financial position: "We can make it until March 1st. – maybe. The State is concerned that if they say yes to bankruptcy, if that door is opened, they'll have 30 more cities right behind us. But anything else is just a stop gap. We're going to continue to pursue bankruptcy until the door is shut, locked, barricaded and bolted." Summer Minnick, director of state affairs for the Michigan Municipal League commented: "There could be many Michigan cities in this position next year, since several had already struggled with billions less than expected in State revenue sharing. All our communities have done is cut, cut, cut. They're down to four-day work weeks and the elimination of parks, senior centers, all of that. So, if there's anything else that happens, they will be over the edge." Along with Prichard, Alabama, this municipal story will likely be repeated all across America over the next two years at least.
- In a bid to attract foreign investment in Russia, Prime Minister Vladimir Putin promises to loosen restrictions on foreign investment in some (economic) sectors during 2011; while separately President Dmitry Medvedev reiterates his pledge to improve what he calls Russia's "bad" investment climate. Over recent years, the ugliness of the sanctioned murder of Sergei Magnitsky and the unlawful imprisonment of Mikhail Khodorkovsky by the Russian leadership; together with the big increase in state ownership and regulation, has stifled economic growth and deterred vital investment. The latest high-profile criticism of the Kremlin's stance on business comes from Vladimir Potanin, owner of the Interros metals, media and banking holding company and one of Russia's wealthiest businessmen. In a recent interview, Mr. Potanin stated: "There is less and less space for independent business. To transact business, you need a powerful partner – either a large company, or the authorities." Can or will these Kremlin leopards change their spots? At Long Wave Analytics, we seriously doubt it. Whither Mother Russia when the crude oil and natural gas resources are depleted?

- According to Admiral Robert Willard, the top American commander in the Pacific, a new Chinese anti-ship ballistic missile, which was designed to threaten U.S. aircraft carriers in the region, has reached "initial operational capability." The admiral's remarks signal that China is challenging the American ability to project military power in Asia much sooner than the U.S. expected. See also, Winter Warning, December 20, 2010 – The 100 Year Economic Leadership Cycle.

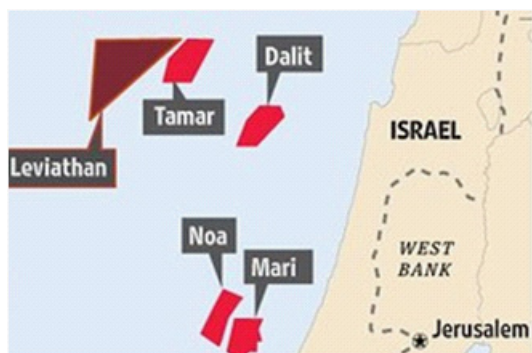
### WEDNESDAY, DECEMBER 29TH

- The Federal Statistics Office reports Germany's inflation rate increased to 1.9% in December from 1.6% in November, on a year-over-year basis, citing an accelerated pace of retail sales
- General Electric (GE) is finalizing plans for a 50/50 joint venture with Aviation Industry Corp. of China, a military jet manufacturer, to produce avionics – the electronic technology for aircraft. The plan gives GE access to a Chinese government project challenging Boeing and Airbus in the civilian aircraft market. Separately, General Motors (GM) is establishing a joint venture with SAIC Motor Corp. its long-time partner in China, to produce and sell their Wuling brand microvans in India and eventually, in the emerging markets of southeast Asia. See also, Winter Warning, December 20, 2010 – The 100 Year Economic Leadership Cycle.
- China's Commerce Ministry announces an export quota of 14,446 tonnes of rare earth minerals for the first half of 2011, significantly lower than the 22,282 tonnes exported in the first half of 2010, but higher than the 7,976 tonnes exported in the second half. China, which produces 97% of the world's rare earths, has reduced exports repeatedly over several years, sending prices higher and prompting a rush of mining investments in Canada, Australia and the United States. A rare earth is a mineral which contains one or more rare earth elements as major metal constituents. The rare earth group of 17 elements are crucial for products from BlackBerry devices and iPhones to wind turbines and guided missiles. At Long Wave Analytics, we would not be surprised to see a Chinese company attempt a takeover of Australia's BHP Billiton at some point.
- The U.S. Treasury auctions \$35 billion of 5-year notes at an average yield of 2.15%, up 74 basis points from the previous auction on November 23rd. and with a bid-to-cover ratio of 2.61 times, the lowest since 2.58 times last June. The bid-to-cover ratio gauges demand by comparing total bids with the amount of notes being offered for sale. According to Concord Coalition, the U.S. national debt has just exceeded the \$14 trillion mark. God help America!

- In a U.K. Telegraph article entitled Italy's Debt Costs Approach Red Zone, International Business Editor Ambrose-Evans Pritchard notes Italy's borrowing costs have jumped to the highest level since the financial crisis over two years ago, raising concerns that Europe's biggest debtor may slip from the euro zone's stable core into the high-risk group on the periphery. The yield for tenders of a recent auction of 8.5 billion euros of Italy's six-month Treasury Bills averaged 1.7%, up 22 basis points from a month ago. As a result, 10-year bonds rose 10 basis points in yield to 4.86%. This disappointing auction in Rome may be a warning sign that European Union (EU) leaders offered too little to restore confidence at their Brussels summit two weeks ago. Willem Buiter, Citigroup's chief economist, warned: "The response was woefully inadequate, raising the risk of fresh bank failures and a wave of sovereign defaults next year. The EU authorities may need a mix of measures worth up to 2 trillion euros to stop the rot." Neil Mellor, currency strategist at the bank of New York Mellon commented: "Big institutional investors have been switching out of Italian bonds and into German debt on a large scale. Our flow data shows that the trend has been just as concerted out of Italian debt as it has been out of Irish or Greek debt. Italy should be able to weather 2011 in good shape, but the government's debt dynamics are very poor."
- In order to pay its outstanding bills, the Illinois State Legislature mulls the option of raising income taxes while Governor Pat Quinn floats the idea of borrowing \$15 billion (U.S.). In a recent interview with the Chicago Tribune, Gov. Quinn remarked: "We're working on a variety of options; nothing has been finalized, but clearly in January, we have a rendezvous with reality. I am talking to legislators of both parties in both houses about how to put it all together." In the meantime, the State continues to spend far more than its revenues and by mid-2011, the budget deficit is expected to reach \$15 billion (U.S.), which includes an estimated \$8 billion (U.S.) in unpaid bills. God help Illinois!
- Indiana Governor Mitch Daniels and Republican State Senator Ed Charbonneau sponsor a bill which would allow municipal governments, amid a declaration of bankruptcy, to apply to the Indiana Distressed Appeals Board to appoint an "emergency manager" to be in charge of the government; and who would have the power to cut the budget, renegotiate labour contracts; as well as approve or veto contracts, expenses, loans and hiring. Currently, State law does not allow Indiana (municipal) governments to declare bankruptcy. However, the new bill states that if the emergency manager is unable to reverse the local government's financial situation, the municipality would be permitted to seek federal bankruptcy protection. God help Indiana!

## THURSDAY, DECEMBER 30TH

- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 34,000 to 388,000 in the week ended December 25th. while continuing claims fell by 57,000 to 4.071 million in the week ended December 18th.
- In a note to clients, Anthony Crescenzi, a portfolio manager with Pacific Investment Management Co. (PIMCO) in Newport Beach, California asserts the U.S. dollar will retain its reserve status in 2011 because China and Europe aren't developed enough for their currencies to replace it: "Rising (economic) powers such as China are not yet ready to absorb the \$9 trillion (U.S.) in reserve assets the world holds, particularly because their bond markets are immature. Europe, amid all of its financial woes, isn't even close to being ready to take the mantle. The United States remains the world's pre-eminent power economically, politically and militarily. The U.S. will remain a 'going concern' and preserve investments in dollar assets, albeit at lower rates of return than in other countries, notably those in emerging markets." At Long Wave Analytics, we have noted that "America must feel threatened by China's growing economic, industrial and military power." (See Winter Warning, December 20, 2010 – The 100 Year Economic Leadership Cycle). Therefore, we are of the opinion that the U.S. will likely retain its reserve currency status in 2011, but mostly by default, since, as Mr. Crescenzi cites, there is no immediate alternative. However, given the enormous American deficit and debt problems at the federal, state and local levels, the U.S.S. Reserve Currency has sprung a huge leak and is steadily sinking.
- The Institute for Supply Management – Chicago manufacturing index rose to a reading of 68.6 in December from a level of 62.5 in November
- The National Association of Realtors reports U.S. pending home sales rose by 3.5% in November, citing its pending home sales index rose to a reading of 92.2 from a downwardly revised level of 89.1 in October
- Houston, Texas-based Noble Energy Inc. confirms its previous estimates that its giant Leviathan offshore gas field near Israel, contains 16 trillion cubic feet of natural gas – making it the world's biggest deep water gas find in decade – with enough reserves to supply Israel's gas demands for 100 years



- According to the Office of the Comptroller of the Currency and the Office of Thrift Supervision, the number of American homes entering foreclosure rose by 31% in the 3rd. quarter compared with the second quarter, citing fewer borrowers qualifying for mortgage modifications. These newly foreclosed homes will add to a growing backlog of 1.2 million homes in some stage of repossession, a 4.5% increase over the second quarter. As of the end of September, 187,000 homes had completed the foreclosure process – a 14.7% increase over the 2nd. quarter. The regulators also found that home retention actions, such as interest and principal reductions, had fallen by 17% from the same period in 2009, mainly because of a sharp drop in mortgage modifications under the government's home affordable modification program (HAMP). Moreover, according to the Congressional Oversight Panel, 40% of mortgagors who receive a HAMP loan modification are expected to default again during the following five years.
- According to a recent report by the Institute of International Finance (IIF), a Washington-based banking lobby group, in March 2008, there were about \$25 billion (U.S.) of investment grade commercial real estate loans in distress. Two and a half years later, the IIF figures that number had exceeded \$375 billion (U.S.), of which "the banks have dealt with potential delinquency problems in part by extending mortgage maturities to 2011-13 to avoid realizing losses; a process known as evergreening." While this has avoided defaults in the short term, the IIF calculates about \$1.4 trillion (U.S.) of commercial real estate loans must be refinanced before 2014. The IIF adds: "At present, nearly half of these properties are underwater, i.e. they have mortgages in excess of the current value of the property." If bond yields continue to rise across the yield curve during 2011, the refinancing of maturing commercial real estate mortgages will be something to which investors should pay close attention.

- The Venezuelan government devalues its bolivar currency for the second time in 12 months, eliminating the foreign exchange rate of 2.6 bolivars to the U.S. dollar. The socialist government hopes the move will attract foreign funds, improve its balance sheet and make the local private sector more competitive. Miguel Octavio, an analyst with BBO financial services commented: "Politically, it is the right thing to do. The government is devaluing now in order to avoid it in 2012 and take the inflationary hit in 2011. It's brutal for the ordinary Venezuelan because it will affect food and medicine prices."

#### FRIDAY, DECEMBER 31ST

- Gold bullion closes the year trading at \$1,421.40 (U.S.) by recording a 10th. consecutive annual gain, as investors seek a safe haven from alternative securities, such as European sovereign debt bonds and U.S. Treasuries. Meanwhile, silver has closed the year trading at \$30.94, up over 80% from its 2009 close of \$17.00 (U.S.) per ounce. The lesser known precious metals, palladium and platinum have also both been stellar performers over the last year, rising by 95% and 15%, respectively.
- Estonia becomes the first former Soviet republic to join the euro and is likely to be the last new member for several years; with Latvia and Lithuania targeting 2014 for euro membership. Estonia's gross domestic product (GDP) of 14 billion euros (\$19 billion U.S.) makes it the second smallest euro economy after Malta. Finance Minister Jurgen Ligi commented: "Estonia is too small to allow itself the luxury of full independence."
- The European Union's charter includes respect for the rule of law, human rights, economic progress and media freedom. The Brussels-based European Commission (EC), the European Union's (EU) executive body, is wondering whether Hungarian Prime Minister Viktor Orban has read it. In the seven months since he came to power with a two-thirds parliamentary majority, Mr. Orban has implemented retroactive taxes in violation of the constitution, curbed the Constitutional Courts power, effectively nationalized private pension funds and placed ruling-party allies in charge of at least four independent institutions, including the audit office. A new media law approved this month empowers a new council – appointed by the ruling party – to fine or close media outlets. The European Central Bank (ECB) recently "raised concerns" about the independence of Hungary's central bank after the government cut the salary of Magyar Nemzeti Bank President Andras Simor and prohibited him from naming outside members to the Monetary Council. Hold it! Are we writing about Hungary here, or Russia?

- In a Wall Street Journal op-ed entitled Home Prices Are Still Too High, Euro Pacific Capital President Peter Schiff warns: "With a bleak U.S. economic prospect stretching far out into the future I feel that a 10% dip below the 100-year trend line is a reasonable expectation within the next five years particularly if mortgage rates rise to more typical levels of 6%. That would put the (10-city Case Schiller) index at 114.02, or prices 28.3% below where they are now. Even a 5% dip would put the index at 120.36 or, 24.32% below current prices. If mortgage rates stay low, price dips may be less severe, but inflation will be higher. From my perspective, homes are still overvalued not just because of these long term price trends, but from a sober analysis of the current economy. America is overly indebted, savings-depleted and underemployed. Without a government guarantee, no private lenders would be active in the mortgage market, and without ridiculously low (administered) interest rates from the Federal Reserve, any available credit would cost home buyers much more. These are not conditions that inspire confidence for a recovery in house prices. In trying to maintain artificial home prices, government policies are preventing new buyers from entering the market, exposing taxpayers to untold trillions in liabilities and delaying a real housing recovery. We should recognize this reality and not pin our hopes on a return to home price normalcy that never was that normal to begin with."

- The Canadian provinces are on a pace to record combined deficits of \$26.6 billion (CAD) in fiscal 2010 -11, a gap that has grown 20 times larger in the two years since the global economic collapse. Just three provinces are expected to balance their budgets this year – Alberta, Saskatchewan and Newfoundland and Labrador – thanks to recovering resource prices. For the others, the path back to a balanced budget will be long and fraught with hard choices among tax increases, cuts to social programs and downsizing the civil service. Ontario, for example, isn't expecting to be back in the black for another seven years, and achieving that will depend upon uncharacteristic spending restraint. Glen Hodgson, chief economist at the Conference Board of Canada warns: "Canadians may think we are still living in the golden age, but times have changed. It's not clear that Canadians are ready to have an adult conversation about what a sustainable fiscal policy entails at the provincial level."

Highest Debt-to-GDP		Lowest Debt- to-GDP	
Quebec	48.3%	Alberta	5.2%
Nova Scotia	39.6%	Saskatchewan	6.7%
Ontario	36.0%	British Columbia	16.0%
Newfoundland	35.2%	Manitoba	25.4%
New Brunswick	33.5%	Prince Edward Island	32.5%

Source: Globe and Mail

CLOSING LEVELS FOR FRIDAY, DECEMBER 31ST.

WEEKLY CHANGE

Dow Jones Industrial Average	11,577.50	+ 4.00 points
Spot Gold Bullion (February)	\$1,421.40 (U.S.)	+ \$40.90 per oz
S&P / TSX Composite	13,443.20	+ 60.0 points
10-Year U.S. Treasury Yield	3.29%	- 11 basis points



Ian A. Gordon, The Long Wave Analyst [www.longwavegroup.com](http://www.longwavegroup.com)

Disclaimer : This information is made available by Long Wave Analytics Inc. for information purposes only. This information is not intended to be and should not to be construed as investment advice, and any recommendations that may be contained herein have not been based upon a consideration of the investment objectives, financial situation or particular needs of any specific reader. All readers must obtain expert investment advice before making an investment. Readers must understand that statements regarding future prospects may not be achieved. This information should not be construed as an offer to sell, or solicitation for, or an offer to buy, any securities. The opinions and conclusions contained herein are those of Long Wave Analytics Inc. as of the date hereof and are subject to change without notice. Long Wave Analytics Inc. has made every effort to ensure that the contents have been compiled or derived from sources believed reliable and contain information and opinions, which are accurate and complete. However, Long Wave Analytics Inc. makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions which may be contained herein, and accepts no liability whatsoever for any loss arising from any use of or reliance on this information. Long Wave Analytics Inc. is under no obligation to update or keep current the information contained herein. The information presented may not be discussed or reproduced without prior written consent. Long Wave Analytics Inc., its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein. In addition, the companies referred to herein may pay a fee to Long Wave Analytics Inc. to be listed on [www.longwavegroup.com](http://www.longwavegroup.com). Copyright © Longwave Group 2010. All Rights Reserved.

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