Monday January 3rd, 2011

LONGWAVE group

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

# THAT WAS THE WEEK THAT WAS


## Monday, January 3rd

The Tempe, Arizona based Institute for Supply Management's manufacturing index rose to a reading of 57 in December from a level of 56.6 in November

## MONDAY, JANUARY 3RD

- Bank of America Corp. (B of A) resolves disputes with Freddie Mac and Fannie Mae by agreeing to pay more than $2.6 billion (U.S.) to settle claims that it sold mortgages during 2008 based upon faulty information. In a statement B of A explained: "The agreement provides for a $1.28 billion (U.S.) cash payment to Freddie Mac to resolve claims arising from 787,000 mortgages sold during 2008 by subsidiary Countrywide Financial Corp. The B of A also agreed to pay $1.34 billion in cash to Fannie Mae, after applying certain credits to an agreed-upon settlement of $1.52 billion (U.S.)."
  Once again the disaster legacy of retired B of A President and CEO Ken Lewis, emerges as a spectre from the past to bite the B of A in the backside. See also, Winter Warning, February 2, 2009 – The Clash of Cultures.

- The Commerce Department reports U.S. construction spending rose by 0.4% in November, following a gain of 0.7% in October, citing government stimulus funding for public schools, office buildings and water supply plants

- According to the American Bankruptcy Institute, U.S. consumer bankruptcy filings rose by 9% in 2010 compared to 2009, totaling 1.53 million – exceeding the 2005 prior high

- In a report last September, Moody's Investors Service forecast: "The State of Illinois faces possible further financial deterioration." In an update on December 29th. Moody's criticized the widening gap between Illinois' revenues and expenses: "This disparity underscores the State's chronic unwillingness to confront a long-term, structural budget deficit." Dan Hynes, the State's retiring comptroller warns: "This fiscal mess is largely of the lawmakers' own making, and failure to address the shortages threatens public schools, local governments and other public services. We've reached a very critical and concerning point. What's missing right now is a general understanding by the public of where we are, of how bad it is, and what the fallout would be if we don't deal with it properly." According to the Center on Budget and Policy Priorities, a Washington-based research group, Illinois' deficit, about half its $26 billion (U.S.) general fund budget, places it among the American states confronting $140 billion (U.S.) in budget shortfalls in fiscal 2012. Accordingly, lawmakers meeting in Springfield will consider spending cuts, an expansion of casino gambling, increasing the State income tax to 4% from 3% and a proposal from Democratic Governor Pat Quinn to borrow $15 billion (U.S.) to pay overdue bills and narrow the budget gap. In addition, Governor Quinn needs Senate approval of a borrowing plan to make the current fiscal year's payment into State pension funds. The State's high borrowing record is what Moody's, Comptroller Hynes and bond investors define as a major reason why Illinois' financial situation deteriorated so far, so fast. God help Illinois!

- According to the UK Telegraph, global debt markets could encounter a second European credit crisis within months, as fears mount over the 900 billion euros of maturing debt which must be refinanced by governments and banks during 2011. Last week, the Centre for Economic and Business Research forecast a new euro zone crisis as its top prediction for the year, noting that Spain and Italy alone must refinance in excess of 400 million euros of maturing bonds in the spring. The chief executive of one major U.K. retail bank informed The Sunday Telegraph that he thought things could get "sticky" in the first half and that his bank was accelerating its debt issuance plans. In its most recent financial stability review, the European Central Bank (ECB) warned: "of a risk of increasing competition for funding, the continuing uncertain macroeconomic outlook and market concerns over the financial position of some peripheral euro zone countries." The Bank of England has also recently warned: "U.K. and European banks remain vulnerable to strains in funding markets. This reflects their continued dependence upon short-term domestic and foreign currency wholesale funding and the challenge of refinancing substantial amounts of term loans and public sector support by the end of 2012."

- According to the New York Times, across America a rising irritation with public employee unions is palpable, as a wounded economy has blown gaping holes in state, city and town budgets, and revealed that some public pension funds dangle perilously close to bankruptcy. In California, New York, Michigan and New Jersey, states where public unions wield much power and the culture historically tends to be pro-labour, since long-time liberal political leaders have even demanded concessions – wage freezes, benefit cuts and tougher work rules. It is an angry conversation. Union leaders, who sometimes have persuaded members to accept pension enhancements in lieu of raises, are loathe to surrender ground. Taxpayers are split between those who hope that increasing tax revenues might result in easier choices. Moreover, a growing cadre of political leaders and municipal finance experts argue that much of the edifice of municipal and state finance is jury-rigged and, without new revenue, perhaps unsustainable. Too many political leaders, they argue, acted too irresponsibly, failing to either raise taxes or cut spending. A brutal reckoning awaits, they suspect.

## TUESDAY, JANUARY 4TH

- U.S. new factory orders rose by 0.7% in November, following a downwardly revised decline of 0.7% in October

- The Luxembourg-based European Union (EU) statistics office reports euro zone consumer prices rose by 2.2% in December on a year-over-year basis, following a 1.9% increase in November, citing higher food and energy prices

- The Nuremburg-based Federal Labour Agency reports while Germany's unemployment rate remained unchanged at 7.5% in December, the number of people out of work increased by a seasonally adjusted 3,000 to 3.15 million, citing job layoffs in the construction and transportation sectors due to the extremely cold weather

- The U.K. Markit/Cips purchasing managers' manufacturing index rose to a reading of 58.3 in December, citing "new export orders from mainland Europe, the U.S. and Asia"

- In a U.K. Telegraph op-ed entitled: Overheating East to Falter Before the Bankrupt West Recovers, International Business Editor Ambrose Evans-Pritchard outlines his economic outlook for 2011. "It would be joyous indeed, if a fresh cycle of global (economic) growth were safely underway, but I don't believe it. Policy levers in the United States, Europe and Japan remain set on uber-stimulus with the fiscal (deficit) pedal pressed to the floor and (interest) rates near zero everywhere; yet OECD industrial output has not regained the peaks of 2007 – 2008 by a wide margin. Leading (economic) indicators are tipping over again. We are one shock away from a liquidity trap. The (Far) East / West trade and capital imbalances that lay behind the Great Recession are as toxic as ever. Dangerously high budget deficits of 6%, 8%, or 10% of gross domestic product (GDP) in countries with dangerously high public debts near 100% of GDP, may have prevented an acute depression, but they have not prevented the weakest (economic) rebound since World War II and they cannot continue. Cyclical (equity) bulls may see the surge in the 10-year U.S. Treasury (yield) – and therefore mortgage yields – as a sign that (economic) growth is about to blast off. Structural (bond) bears suspect it may be the first convulsive bond vigilantes dismayed at the easy willingness of Washington to spend $1.4 trillion (U.S.) above revenues next year, with no credible plan to contain the (debt) monster thereafter. Can bond yields rise on 'sovereign (debt) risk' even as core prices grind lower towards deflation? Yes, they can, and this baleful possibility is not in the textbooks. Alas, my neck-sticking predictions for 2011 must be as grim as ever. This does not exclude further bear (market) rallies over the Spring on Wall Street and Euro-bourses as institutional mammoths, seek to extract themselves from bonds."

- According to the Salt Lake Tribune, a proposal in the Utah Legislature would require State government agencies to accept gold for the settlement of transactions and create a parallel monetary policy for intrastate commerce tied to the price of gold. Under the drafted legislation, Utah residents could mint their own gold or silver coins; a storehouse would be created to stockpile the precious metal and the Utah Defense Force (an arcane State militia that may be called and armed by the Governor) would be responsible for securing the inventories. State Representative John Dougall (R-Highland) explained: "What it comes down to is people's concern about the fundamentally reckless policies at the Federal Reserve and what it does long-term to the financial standing of the country and giving folks another choice of monetary tools for their financial transactions." Larry Hilton, an attorney who authored the "Utah Sound Money Act" remarked: "If the (U.S.) dollar falters, it would be beneficial to the State to have an alternative. It's not intended to be compulsory in any way. The State is offering to taxpayers: If you want to pay your taxes in gold or silver, we'll accept them." According to the Act: "Intrastate Commerce Co-operatives may be formed and contract with the State to store the State gold and silver holdings and aid in commerce."

- In the most recent Bullion Management Group newsletter entitled The New Gold Rush, President and CEO Nick Barisheff forecasts: "As confidence in global currencies wanes, the world's appetite for gold will increase. In 2009, gold officially became money once again when central banks around the world, including those of China, India and Russia, became net buyers for the first time in nearly 20 years. We believe that central banks are preparing for a return of some form of the gold standard. Gold does not rise: currencies lose purchasing power against gold. Milton Friedman, the renowned American economist stated: 'Nations are not ruined by one act of violence, but gradually and in an almost imperceptible manner, by the depreciating of their circulating currency, through excessive quantity.' Gold has intrinsic value because it is difficult to find, to mine and to refine. In his book, 'The Golden Constant,' Professor Roy Jastram demonstrated that gold's purchasing power remained remarkably stable between the years of 1560 and 2007. Gold bullion ownership best serves the purpose of wealth preservation. This has been the case for thousands of years and will continue to be so. Since gold appears to be rising due to currency debasement, we need to discover whether governments will continue to spend and whether inflation will continue to rise. Three irreversible trends indicate that this pattern will persist for years to come. They are the aging population, outsourcing (of jobs) and peak oil." See also, Winter Warning, October 19, 2009 – All That Glitters Is Gold

- In the minutes from its December 14th. Federal Open Market Committee (FOMC) meeting, the U.S. Fed acknowledges: "Committee members generally agreed that, even with the positive news received over the inter-meeting period, the most likely outcome was a gradual pickup in (economic) growth with slow progress toward maximum employment, but not sufficient to warrant any adjustment to the asset purchase program."

## WEDNESDAY, JANUARY 5TH

- In his monthly investment outlook note to clients, Pacific Investment Management's (PIMCO) managing director Bill Gross warns: "All investors should fear the consequences of 'mindless' U.S. deficit spending, which may result in higher inflation, a weaker dollar and the eventual loss of America's 'AAA' credit rating. The problem is that politicians and citizens alike have no clear vision of the costs of a seemingly perpetual trillion dollar annual deficit. As long as the stock market pulsates upward and job growth continues, there is an abiding conviction that all is well and that 'old norms' have returned. Not likely. There will be pain aplenty. Stimulus measures, that have been designed to maintain current consumption instead of working to make America a more competitive nation; in the long run, will be a drag on real income growth as reflationary policies set in." California-based PIMCO manages the world's largest bond fund. See also, Winter Warnings, September 22, 2008 – The Die Is Cast and The Flight to Folly; and January 11, 2010 – It's the Debt, Stupid

- The Canadian Federation of Independent Business monthly confidence index rose to a reading of 59.3 in December

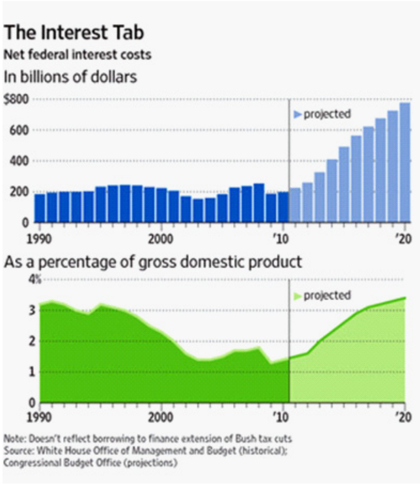
- The Institute for Supply Management's U.S. non-manufacturing index rose to a reading of 57.1 in December from a level of 55 in November, citing some improvement in the services sector of the economy

- China's Vice Premier Li Keqiang announces the signing of $7.3 billion (U.S.) of commercial agreements with Spain, after reiterating Beijing's pledge to support the Spanish economy. While the contracts involve 16 sectors including energy, banking, telecommunications, transportation and agriculture; by far the most valuable one was the closing of a previously announced $7.1 billion (U.S.) acquisition of certain Brazilian assets of Spanish oil firm Repsol YPF SA by China Petroleum and Chemical Corp. (Sinopec). Mr. Keqiang elaborated: "China is a long-term and responsible investor in the Spanish and European financial markets, and it has confidence and great interest in the Spanish market."

- According to ADP Employer Services, U.S. companies added 297,000 jobs to their payrolls during December, following a downwardly revised increase of 92,000 in November

- In a Washington Post op-ed entitled Corporate America – Paving a Downward Economic Slide, columnist Harold Myerson laments: "We are now America, the downwardly mobile. The decade just concluded is the first in which Americans, on average, have seen their incomes decline. Until the housing and financial bubbles burst, of course, we enjoyed the illusion of prosperity through the days of wine and credit. Now we stand on unfamiliar terrain in which almost all the signs of long-term economic health point downward. Our private sector isn't creating jobs at a rate commensurate with our increasing population, much less at a level to significantly reduce unemployment. The social pathologies long associated with the inner-city poor, single-parent households, births out of wedlock and drug and alcohol abuse, now stalk the white working class in rural and post-industrial regions far removed from big cities. The middle is falling. This grim new reality has yet to inform our debate over how to come back from this mega-recession. While many believe that our economic downturn is either cyclical or structural, I believe that it's institutional; that it's the consequence of the decisions by leading banks and corporations to stop investing in the job-creating enterprises that were the key to broadly shared prosperity. Our multinational companies still invest, of course, just not at home. A study by the Business Roundtable and the U.S. Council Foundation found that the share of the profits of U.S.-based multinationals that came from their foreign affiliates had increased from 17% in 1977 to 48.6% in 2006. As the companies' revenue from abroad has increased, their dependence upon American consumers has diminished. Making and selling their goods abroad, U.S. multinationals can slash their workforces and reduce their wages at home while retaining their revenue and increasing their profits; and that's exactly what they've done. Our solutions must be similarly institutional, requiring for openers, the seating of public and worker representatives on corporate boards. Short of that, there will be no real prospects for reversing America's downward mobility."

- U.S. Treasury Secretary Timothy Geithner urges lawmakers to raise the federal debt limit from its current level of $14.29 trillion during the first quarter; citing failure to act could make it impossible for the United States to access global credit markets. In a letter to Senate Majority Leader Harry Reid, Secretary Geithner warns: "If Congress does not raise the debt limit, the U.S. Treasury would be forced to default on legal obligations of the United States, causing catastrophic damage to the economy, potentially much more harmful than the effects of the financial crisis of 2008 and 2009." Since the national debt currently stands at $14.04 trillion, the Treasury estimates the debt limit could be reached as soon as the end of March. In a prepared statement, House Speaker John Boehner (R-Ohio) remarked: "While America cannot default on its debt, we also cannot continue to borrow recklessly, dig ourselves deeper into this hole and mortgage the future of our children and grandchildren." Surely Mr. Geithner has been in the employ of the U.S. government long enough to understand that in the current environment of political gridlock, compromise and brinkmanship are the order of the day. One thing is for certain, neither Mr. Geithner, nor Mr. Boehner, will risk the forfeiture of his April pay-packet.




- The Labor Department reports U.S. claims for state unemployment benefits rose by 18,000 to 409,000 in the week ended January 1st. while continuing claims declined by 47,000 to 4.1 million in the week ended December 25th.

- The European Commission (EC) is proposing an area wide framework, for confronting bank and investment dealer failures, that urges bondholders to share the financial burden. The EC is seeking investor feedback regarding whether bank bondholders should share in paying for future financial bailouts.

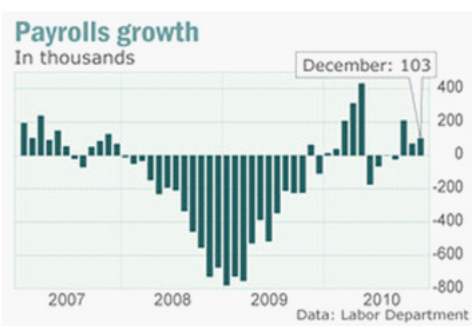
## THURSDAY, JANUARY 6TH

- The Economy Ministry reports German factory orders rose by 5.2% in November, following a 1.6% gain in October. Ralph Solveen, an economist at Commerzbank AG in Frankfurt commented: "Exports are decisive but domestic demand is picking up as well. Germany continues to be the driving force in the euro region."

- In a company website article, PIMCO's managing director Bill Gross laments: "Unlike Europe or the United Kingdom, which appear to have gone on an extreme fiscal diet, the American answer to a bulging waistline is always manana (tomorrow). Debt commission recommendations are tossed in the trash can, tea party election rhetoric eventually focuses on miniscule and merely symbolic earmarks, and both Democrats and Republicans congratulate each other on their ability to reach a bipartisan agreement for the good of the nation. If America must pay an eventual price for mindless deficit spending, then (investors should) find countries and currencies that appear to have their act under control: Canada, Brazil and even Mexico with its drug-related violence." At Long Wave Analytics, we applaud PIMCO's endorsement of Canada – better late than never!

FRIDAY, JANUARY 7TH

- The Labor Department reports U.S. non-farm payrolls increased by 103,000 in December, while the nation's unemployment rate declined to 9.4% from 9.8% in November. John Silvia, chief economist at Wells Fargo, commented: "The lower unemployment rate is a mixed blessing, since the participation rate fell as the labor force declined. While more people are finding employment, (the economy) appears to be losing people into the woodwork – not a good sign (for) the long term." Of the 14.5 million persons unemployed in December, 44.3% have been jobless for at least six months. A more broadly-based measure of the unemployment rate, which includes discouraged workers and those forced to work part-time because of the weak economy, declined to 16.7% in December from 17% in November.




- U.S. Defense Secretary Robert Gates announces $78 billion (U.S.) of cuts in the Pentagon's budget over the next five years: "The United States faces extreme fiscal distress and the Pentagon cannot presume to exempt itself from the scrutiny and pressure faced by the rest of our government."

- In testimony before the Senate Budget Committee, Federal Reserve Chairman Ben Bernanke stated: "Although still somewhat fragile at the moment, we have seen increased evidence that a self-sustaining recovery in consumer and business spending may be taking hold. The pace of (economic) growth (gross domestic product) seems likely to be moderately stronger in 2011 than it was in 2010, however, it could take four to five more years for the job market to normalize fully." Mr. Bernanke also urged Congress to craft a credible program to lower the federal budget deficit, warning the government is now on an unsustainable fiscal path that might lead to broad financial turmoil if left unaddressed. "The deficit (reduction) plan has to be one that (the) markets will accept as plausible." At Long Wave Analytics, we have absolutely no confidence that Congress will draft, a deficit reduction plan, let alone one that is plausible.

- James Callon, who holds the Office of the Superintendent of Bankruptcy Canada, warns: "It's important for Canadians to be aware of the risks and possible consequences of taking on a large amount of debt. Significant events such as a change in employment or income, a change in family status or a serious illness, can cause a huge drain on finances. The combination of a large amount of debt and the sudden occurrence of a major life event could lead to the harsh realities of insolvency. While the number of insolvencies – bankruptcies and proposals – filed during the 12 months ending October 2010 was less than the number filed during the previous 12 months; the number of consumer insolvencies filed in Canada was still 22.5% higher than the levels (prevalent) during 2007 and 2008."

CLOSING LEVELS FOR FRIDAY, JANUARY 7, 2011
WEEKLY CHANGE

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| Dow Jones Industrial Average | 11,674.80 | + 97.30 points |
| Spot Gold Bullion (February) | $1,368.90 (U.S.) | – $52.50 per oz |
| S&P/TSX Composite | 13,272.30 | + 170.90 points |
| 10-year U.S. Treasury Yield | 3.31% | + 2 basis points |
| Canadian Dollar | 100.83 cents (U.S.) | + 1.64 cents |