

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



Monday, December 19th

The Washington-based National Association of Homebuilders / Wells Fargo index of builder confidence rose to a reading of 21 in December – the highest level since May 2010 – from an upwardly revised reading of 19 in November. John Herrmann, a

MONDAY, DECEMBER 19TH

fixed income strategist at State Street Global Markets LLC in Boston commented: “We’re just seeing some incremental improvement because it’s too early to say that the worst is over ... and that we’re pulling ourselves out of the morass of the housing market.”

- Front Page Headline, Bloomberg News – “Chinese Debts on Local Projects Dwarf Official Data. A study of Chinese language bond prospectuses issued during this year indicates that debt accumulated by companies financing local governments, such as Tianjin – a huge Manhattan look alike project – is rising. The study also suggests that the total amount owed by all such entities likely dwarfs the official count by China’s national auditor and the figures disclosed by banks. Bloomberg News tallied the debt disclosed by all 231 local government financing companies that issued bonds, notes or commercial paper through December 10th. of this year. The total amounted to 3.96 trillion yuan (\$622 billion U.S.), mostly in bank loans and more than the current size of the European Financial Stability Fund (EFSF). According to a June survey by China’s National Audit Office, there are 6,576 of such entities across China, which puts their total debt at 4.97 trillion yuan. This means the 231 borrowers studied by Bloomberg have alone amassed more than 76% of the overall debt. Fraser Howie, the Singapore-based managing director of CLSA Asia-Pacific Markets – and the author of two books about China’s financial system – commented: “You should be more worried than you think ... certainly more worried than the banks will tell you. Assuredly ... this story will end badly!”
- Front Page Headline, Bloomberg News – “There’s No External Saviour for Countries that Won’t Reform: ECB President Draghi. In a Berlin speech, European Central Bank President Mario Draghi warns: ‘There is no external saviour for a (euro zone) country that doesn’t want to save itself. I will never tire of saying the first response should come from the (member) countries. An unavoidable short-term economic contraction in the euro area may be mitigated by a return of confidence if governments implement budget consolidation plans. In the medium-term, sustainable (economic) growth can be achieved only by undertaking deep structural reforms that have been procrastinated for too long ... Certainly, the ECB’s bond (purchase) program is neither eternal, nor infinite.’”
- Front Page Headline, Bloomberg News – “Euro Zone Governments Provide Additional \$150 Billion Euros to IMF. Luxembourg Prime Minister Jean-Claude Juncker announces euro zone governments will meet a target for increasing their anti-debt crisis fund with a pledge to provide 150 billion euros (\$195 billion U.S.) to the IMF, including non-euro users Sweden, Poland, Denmark, and the Czech Republic.
- Front Page Headline, Daily Telegraph U.K. – “Euro Zone Leaders Created Cycle of Risk: ECB. In a critical Financial Stability Review, the European Central bank concludes: ‘The risks to euro area financial stability increased considerably in the second half of 2011. Positive market responses to European Summit agreements have been short-lived and an uneven ratification

process appears to have contributed to additional market uncertainties. The debt crisis demands bold and decisive action both within and outside the euro area. Swift and effective implementation of the December 9th. Brussels agreement is pivotal ... to curtailing the cycle of risk implementation in the euro area that characterized the latter half of 2011.’ In an afternoon speech to the European Parliament, ECB President Mario Draghi backed fiscal union and austerity measures citing: ‘The European Treaty forbids monetary union. Losing credibility for the European Central Bank is not going to do any good for market confidence.’



ECB President Draghi arrives at the European Parliament economic and monetary affairs committee. Source: Daily Telegraph U.K.

Included in the bill is a provision which gives the U.S. military carte blanche responsibility to indefinitely detain ‘suspected terrorists’ – even if they are American citizens residing on U.S. soil. Under this provision, ‘American ‘suspects’ can be detained by the military without charge or trial ... An Obama administration lawyer, who works for the CIA, stated that only the executive branch of government (not the courts) can decide who qualifies as an enemy on a battlefield. Such decisions are not subject to a review and do not require that any evidence be presented showing guilt or association with Al-Queda.”

TUESDAY, DECEMBER 20TH

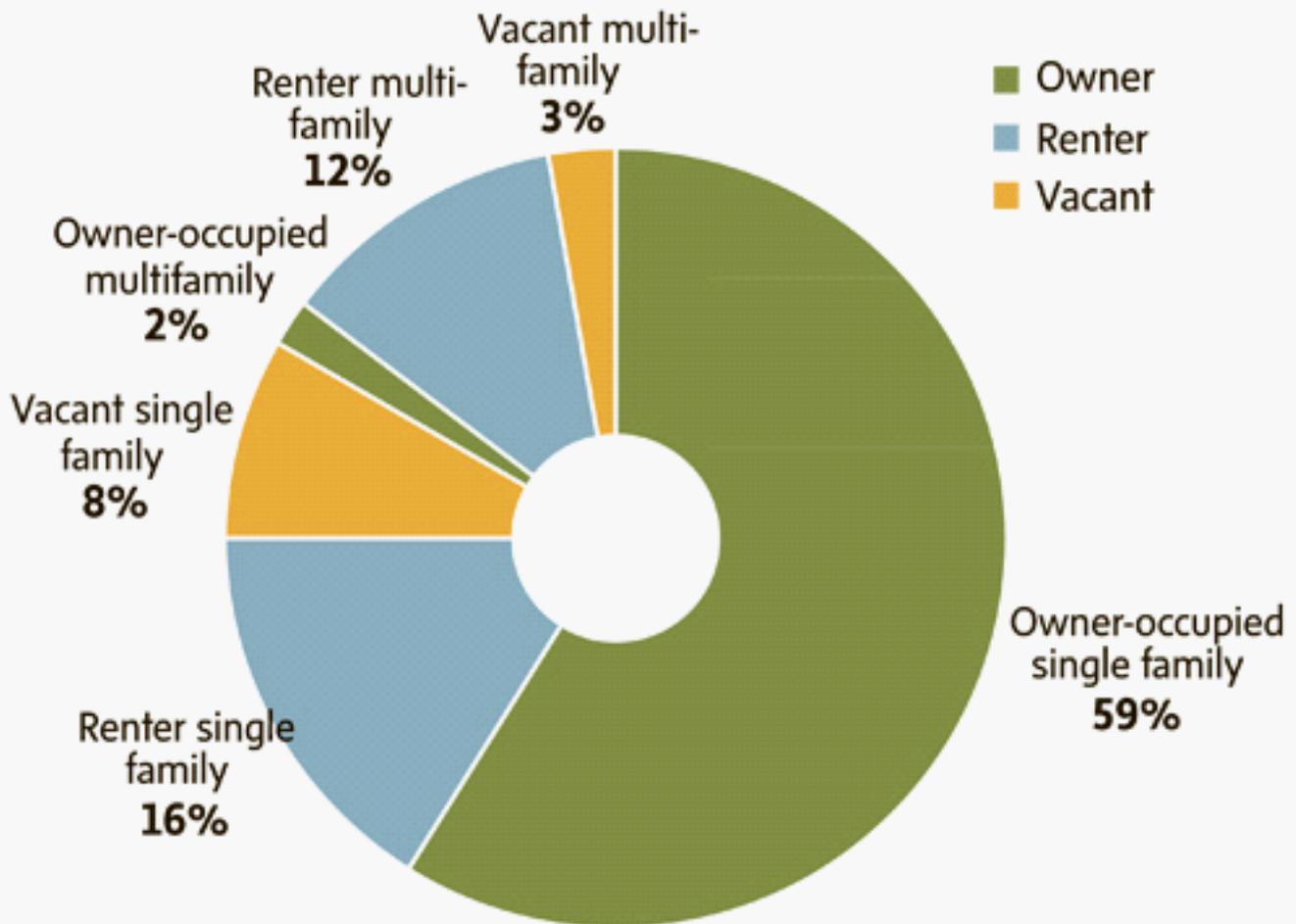
- According to The Privateer: “On December 1st. the U.S. Senate passed a military appropriations bill totaling \$662 billion (U.S.).

- Front Page Headline, Globe and Mail – “Canada’s Housing Boom Among Longest in Western World. In a new study, Bank of Nova Scotia economists report that the average Canadian house has increased in value by 85% since 1998: ‘In 10 countries which we track, the slow pace of the global economic recovery, intensifying sovereign debt concerns, weak consumer confidence and high unemployment all continue to weigh on residential property markets ... Although Canada remained a notable outperformer in the 3rd. quarter, activity here shows some signs of cooling and weaker market conditions will likely persist well into 2012. While the combination of low mortgage rates and lower home prices have bolstered housing affordability, there is insufficient domestic momentum in the majority of advanced nations to support a significant revival in demand. An oversupply of housing and a more cautious lending environment also will restrain the recovery.” Source: Scotia Capital

International House Prices (Inflation-adjusted, y/y % change)													
	2002	2003	2004	2005	2006	2007	2008	2009	2010	10Q4	11Q1	11Q2	11Q3
Australia	15.8	15.4	4.2	-1.2	4.2	9.0	0.1	1.6	9.2	2.0	-3.2	-5.8	-5.7
Canada	7.3	6.9	7.4	7.8	9.2	8.7	-3.1	4.7	4.0	-0.7	5.3	5.1	4.8
France	6.8	9.6	12.8	13.5	10.2	5.0	-2.3	-7.2	3.4	5.7	5.0	4.8	4.4
Germany	-2.3	-2.9	-3.7	-3.9	-1.8	-1.3	-2.8	-0.2	1.9	..	..	..	..
Ireland	5.8	12.3	8.9	10.0	11.8	5.6	-9.0	-16.6	-11.6	-10.4	-11.9	-13.7	-14.7
Italy	9.3	3.4	3.8	5.5	3.6	2.9	-0.9	-1.2	-1.5	-1.5	..	-1.2	..
Japan	-3.7	-5.0	-6.2	-4.8	-3.6	-1.1	-2.6	-2.4	-3.1	..	-2.7	..	-3.3
Spain	13.4	16.9	15.3	11.2	6.5	2.6	-3.9	-7.3	-5.4	-5.7	-8.5	-9.5	-8.9
Sweden	4.2	4.7	9.0	8.6	10.8	8.2	-0.2	1.9	6.6	3.3	1.1	-1.2	-1.9
Switzerland	4.0	2.3	1.6	-0.1	1.4	1.3	0.3	5.5	4.0	3.9	3.8	4.2	3.3
United Kingdom	15.3	14.2	10.8	3.5	3.9	8.8	-4.3	-9.7	4.3	0.3	-4.5	-6.4	-6.7
United States	7.5	4.8	6.3	6.1	-2.0	-5.0	-12.7	-9.3	-0.2	0.2	-4.7	-5.6	-7.5

Source: OECD, Australian Bureau of Statistics, Canadian Real Estate Association, Statistics Canada, INSEE, Irish Department of the Environment, Heritage and Local Government, Central Statistics Office Ireland, Eurostat, Bank of Italy, Istat, Japan Real Estate Institute, Japanese Ministry of Internal Affairs and Communications, Banco de Espana, Instituto Nacional de Estadística, Statistics Sweden, Riksbank, Swiss National Bank, Statistics Switzerland, U.K. Office for National Statistics, U.S. National Association of Realtors, U.S. Bureau of Labor Statistics, Scotia Economics.

## U.S. HOUSING MARKET



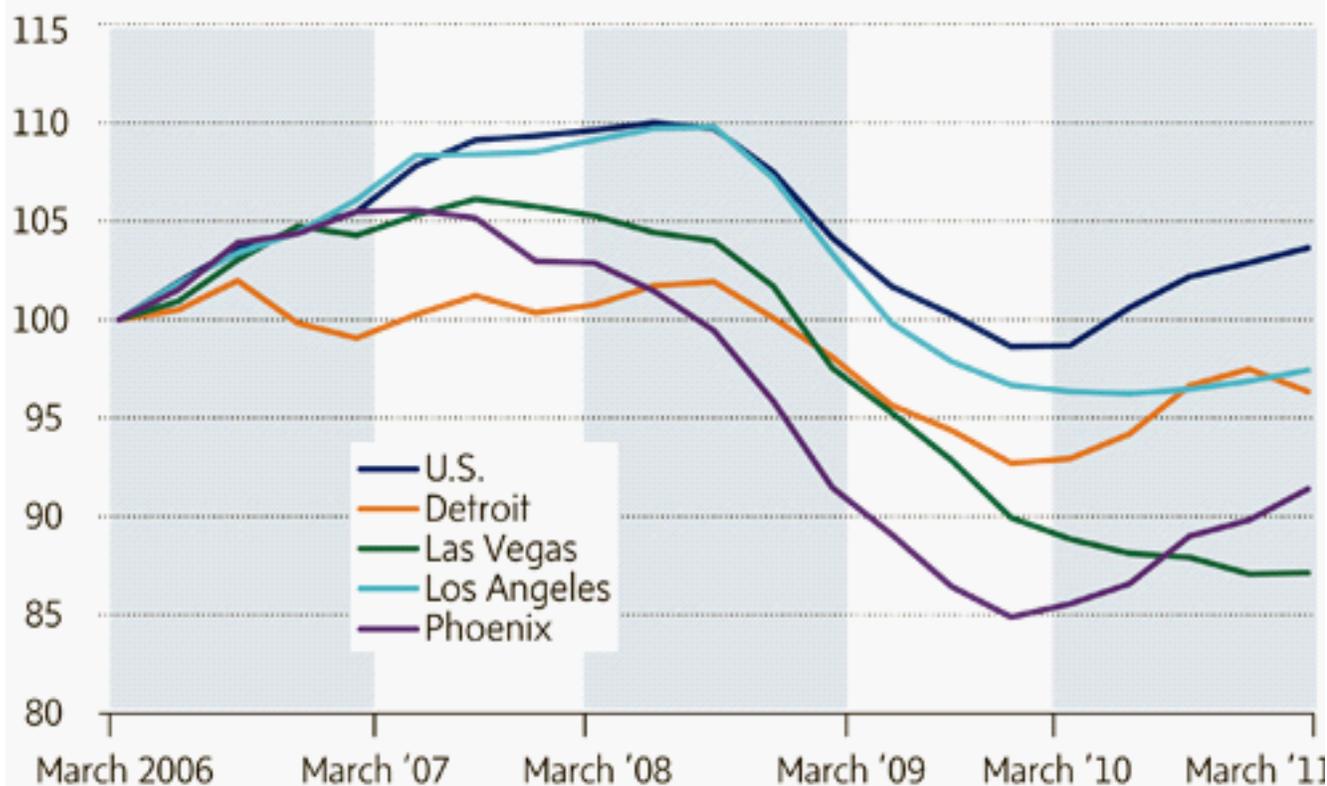
The Globe and Mail - Sources: U.S. Census, Morgan Stanley Research

- Front Page Headline, Globe and Mail – “Fed Issues U.S. Bank Capital, Liquidity Proposals. The U.S. Federal Reserve proposes new capital and liquidity rules for the largest American banks that would be implemented in two phases and likely not exceeding international standards. The first phase would rely upon policies already set by the Fed, such as the capital stress test plan it released in November. That stress test plan will require U.S. banks with more than \$50 billion (U.S.) in assets to show they can meet a Tier 1 common risk-based capital ratio of 5% during a time of economic stress. The second phase for both capital and liquidity would be based upon the Fed’s implementation of the Basel III international bank regulatory agreement. That standard raises the Tier 1 common risk-based capital ratio requirement to 7%, plus a maximum surcharge of 2.5% for the most complex firms.

- The Commerce Department reports U.S. housing starts rose by 9.3% to a 685,000 unit annual pace in November, the most since April 2010, citing a surge in multi-family units
- The Labor Department reports U.S. payrolls increased in 29 states in November, while the unemployment rate declined in 43 states. New York State led the nation with a gain of 29,500 jobs, followed by Texas with 20,800.
- Statistics Canada reports the nation’s consumer price index remained unchanged at 2.9% in November on a year-over-year basis, citing continuing high prices for food and gasoline; as well as tuitions, airfares and financial services
- Front Page Headline, Wall Street Journal – “California Sues Mortgage Giants Freddie Mac and Fannie Mae. California Attorney General Kamala Harris files suit against Freddie Mac and Fannie Mae, pressing for answers to a detailed list of questions, after the firms’ federal regulator – The Federal Housing Finance

## MULTIFAMILY RENTS ON THE RISE

Index: March 2006=100



THE GLOBE AND MAIL » SOURCES: U.S. CENSUS; MORGAN STANLEY RESEARCH

Agency – sought to block an open-ended inquiry by the State. In November, the attorney general’s office issued subpoenas asking the firms to provide extensive answers to a range of questions about the mortgages they purchased and the foreclosed properties they own in California. Earlier this month, the FHFA directed Freddie and Fannie not to comply with the subpoenas, terming them ‘frequently vague and ambiguous’ and asked Ms. Harris to withdraw them. Among other things, the subpoenas asked for a record of every vacant home owned by the companies in the State and asked the firms whether they were aware of drug dealing, prostitution, or the presence of explosives and radioactive material in those homes. The FHFA argued that the State ‘appeared to be engaged in an open-end exploratory investigation that would undermine the FHFA’s authority while placing an extra burden on the operations of the firms. The effort required to collect the voluminous amount of information required to comply would be nothing short of staggering.’

- Front Page Headline, Financial Times – “Moody’s Issues Warning for U.K.’s ‘AAA’ Credit Rating. In its annual report regarding U.K. sovereign debt, Moody’s Investors Service warns: ‘While maintaining a stable outlook, Britain’s deteriorating public finances and economic growth outlook have substantially reduced its ability to maintain its ‘AAA’ sovereign debt credit rating. In addition to domestic risks, Britain would not be immune from a (debt) crisis in the euro zone. Indeed, Moody’s has placed all of its European credit ratings ... under review in a move which could lead to a repositioning of a large number of sovereign debt credit ratings.’”
- Front Page Headline, Washington Post – “Enrica Cotellessa-Pitz Pleads Guilty to Role in Madoff Fraud. The former controller at Bernard Madoff’s investment firm pleads guilty to conspiracy, falsifying books and records and making false filings to the Securities and Exchange Commission (SEC). She faces a maximum of 50 years in prison. According to a charging document, Cotellessa-Pitz helped Madoff cheat on his taxes and with others, altered stock trading records for audits. Cotellessa-Pitz doctored

records to disguise money transfers from Madoff's investment advisory business to another side of his business devoted to market making and proprietary trading, the business area managed by Madoff's sons. The transfers – hundreds of millions of dollars over about a decade – made those operations appear profitable when they were not.

- Front Page Headline, Washington Post – “Europe Could Face Unprecedented Finance Risk in Early 2012. During a two-hour appearance before the European Parliament, European Central Bank (ECB) President Mario Draghi warns: “European governments and banks will be competing to raise hundreds of billions of dollars from investors in the next few months, noting the financing squeeze could help push the region into a new recession. Governments and banks in the euro zone have about \$500 billion (U.S.) in outstanding bonds maturing in the first three months of 2012 and many of these notes must be refinanced with new bond issues. The pressure that bond markets will be experiencing will be very, very significant, if not unprecedented. Next year is going to be a difficult year for the banks. Priority must be given ... to ensure we don't have an economic recession coming from funding pressure. Many banks are unable to issue corporate bonds at affordable yields under current (market) conditions, just as (some) European governments have struggled to issue their (sovereign) bonds. Moves earlier this month towards closer budgetary cooperation among the 17 euro zone nations was an important step, but will do little to relieve the risks of a near term credit squeeze.”

### WEDNESDAY, DECEMBER 21ST

- Front Page Headline, Bloomberg News – “ECB Lends European Banks \$645 Billion (U.S.). The Frankfurt-based European Central Bank lends 523 euro-area banks 489 billion euros in 3-year loans at the average of its benchmark interest rate of 1%. In addition, the ECB has widened the pool of collateral that banks can use to secure the funds (read possible toxic securities). Laurent Fransolet, a fixed income strategist at Barclay's Capital in London commented: ‘Obviously, it was an offer that the banks could not refuse. It shows the ECB is not out of ammunition and it gives banks security on liquidity for a few years. It means banks will be relying upon the ECB for a longer time.
- The Ministry of Finance reports Japan's exports declined by 4.5% in November on a year-over-year basis, citing weaker demand in Europe and Asia. Exporters are calling upon the Bank of Japan to intervene again in the currency markets as the yen is close to a post-war high against the U.S. dollar.



Trucks bound for shipment in Yokohama City Source: Bloomberg

- According to revisions reported by the National Association of Realtors (NAR), an average of 14% fewer existing homes were sold annually between 2007 and 2010, citing an average annual downward revision to 4.42 million units from a prior estimate of 5.16 million units
- Istat, the national statistics institute of Italy, reports the country's gross domestic product (GDP) contracted by 0.2% in the 3rd. quarter ended September 30th. following a 0.3% expansion in the previous quarter; signaling the country may be entering another economic downturn, as the government adopts new austerity measures that will further weigh on economic growth
- Front Page Headline, New York Times – “Countrywide Lending Bias Costs B of A \$335 million (U.S.) Settlement. The U.S. Justice Department announces the largest residential fair-lending settlement in history, citing the Bank of America's agreement to pay \$335 million (U.S.) to settle allegations that its Countrywide Financial unit discriminated against black and Hispanic mortgagors during the housing boom. The Justice Department's investigation concluded that Countrywide had charged higher fees and mortgage rates to more than 200,000 minority borrowers across the U.S. than to white borrowers who posed the same credit risk. It also steered more than 10,000 minority borrowers into costly subprime mortgages, when white borrowers with similar credit profiles received prime loans. The pattern and practice covered the years 2004 to 2008, before Countrywide was acquired by the Bank of America. Wakeup call for the Board of Directors of the Bank of America: You should be researching your legal options to sue former B of A President and CEO Ken Lewis demanding a claw back of his outrageous pension, charging gross incompetence and lack of proper due diligence in the takeover of Countrywide Financial in 2008.”

- Statistics Canada reports the nation's retail sales rose by 1% in October to \$38.6 billion (CAD) – the third consecutive monthly increase – citing a broad range of gains in seven of eleven sub-sectors of goods from food to automobiles
- Front Page Headline, National Post – “Fitch Warns Again on United States Debt. Fitch Ratings warns again that the ‘United States’ rising debt burden is not consistent with maintaining the country’s ‘AAA’ sovereign debt credit rating.’ In November, Fitch changed its U.S. credit rating outlook to negative from stable, citing the failure of a special congressional committee to agree on at least \$1.2 trillion (U.S.) in deficit reduction measures. ‘The U.S. federal debt will rise in the absence of expenditures and tax reforms which would address the challenges of rising health and social security spending as the population ages. At least \$3.5 trillion (U.S.) of additional deficit reduction measures will be necessary to stabilize the federal debt held by the public at around 90% of gross domestic product (GDP), in the latter half of the current decade. A key task of an incoming Congress and administration in 2013 is to formulate a credible plan to reduce the budget deficit and stabilize the federal debt burden. Without such a strategy, the U.S. sovereign debt credit rating will likely be lowered by the end of 2013.”
- Front Page Headline, Financial Times – “American Bond Portfolio Manager Fears Debt Crescendo. Jeffrey Grundlach, Chief Executive Officer of Double Line Capital and this year’s best performing U.S. bond portfolio manager, stands apart mostly for his pessimism on the (bond market) outlook for 2012, when he expects the sovereign debt crisis in Europe to reach a crescendo. “People who are looking for an explosion in bond yields on a better economy are thinking that somehow the world is still in 1995, where we have moderate economic growth, low inflation, a stable tax policy and people cooperating. The 2008 problem was a private economy problem and businesses – the business owners – do try, and are incentivized by laws and penalties, to tell the truth when they have earnings calls every quarter. The difference here is (the fact that) it is not corporately-based. This is a government-based problem and a public economy, public sector problem and the issue that’s so problematic is that the politicians won’t tell you the truth.”

## THURSDAY, DECEMBER 22ND

- Front Page Headline, Market Watch News – “House Republicans Accept Short-Term Extension for Payroll Tax Cut. House Speaker John Boehner announces the House will vote on a Senate-passed bill that would extend the 4.2% payroll tax cut for two months. Under this agreement, Senate Democrats will appoint conferees to meet with House members in the coming weeks in order to arrive at a new agreement which will extend the payroll tax cut for another full year.
- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 4,000 in the week ended December 17th. while continuing claims declined by 79,000 to 3.55 million in the week ended December 10th.
- The Office for National Statistics reports the U.K. gross national product expanded by a slightly revised 0.6% in the 3rd. quarter, previously reported as a gain of 0.5%. James Knightly, an economist at ING Group in London commented: “A return to an (economic) recession is looking increasingly likely. Fiscal austerity is dampening government spending and the deteriorating euro zone economy is a massive threat to U.K. exports.”
- Front Page Headline, Globe and Mail – “Supreme Court of Canada Unanimously Declares Proposed Securities Act Unconstitutional. In a brief statement to the press, Canadian Finance Minister Flaherty commented: ‘We have the Supreme Court decision and we will respect it. It is clear we cannot proceed with this legislation. We will review the court’s decision carefully and act in accordance with it.’ In its ruling, the Supreme Court stated: ‘While the parties presented evidence and arguments on the relative merits of federal and provincial regulation of securities, the policy question of whether a single national securities scheme is preferable to multiple provincial regimes is not one for the courts to decide. Accordingly, our answer to the reference question is dictated solely by the text of the Constitution, fundamental constitutional principles and the relevant case law.’
- Front Page Headline, Wall Street Journal – “U.S. GDP Revised Lower for 3rd. Quarter. The Commerce Department reports U.S. gross domestic product expanded at a revised annual rate of 1.8% in the 3rd. quarter, instead of the 2% pace that was previously estimated. The revision was largely the result of weaker consumer spending in the services sector. Spending on services was revised to a 1.9% annual growth rate from 2.9% in the earlier GDP estimate.”

- Front Page Headline, New York Times – “S&P Downgrades Hungary’s Credit Rating to Junk. Standard and Poor’s Ratings Services downgrades Hungary’s long-term and short-term sovereign debt credit ratings to ‘BB’ (High) / ‘B’ from ‘BBB’ (Low) / ‘A’ (Low), respectively, while maintaining a negative outlook. S&P analysts concluded: ‘The downgrade reflects our opinion that the predictability and credibility of Hungary’s policy framework continues to weaken. Policy changes related to Hungary’s central bank appear to curtail the bank’s independence. Such changes complicate the operating environment for investors. They’re likely to have a negative outlook on investment and fiscal planning, which will weigh on Hungary’s medium-term (economic) growth prospects.’”
- Front Page Headline, Daily Telegraph U.K. - “European Debt Crisis Causing Dangerous Dependence on Central Banks: Sir Mervyn King. At a press conference, following a meeting of the European System Risk Board in Berlin, Bank of England Governor Mervyn King stated: ‘The European debt crisis has been exacerbated by negative inter-linkages. Dependence upon central banks has risen and signs are intensifying that stressed financial conditions are passing through to the real economy. Yesterday’s radical liquidity operation will help in the short term, but I’m seeking longer term solutions, including getting the European Financial Stability Facility (EFSF), the so-called ‘big bazooka’ bailout fund up and running.’”

FRIDAY, DECEMBER 23RD

- The Commerce Department reports U.S. durable goods orders rose by 3.8% in November, citing an increase in demand for aircraft outweighing declines in orders for computers and business equipment. Separately, U.S. new home sales rose by 1.6% to an annual pace of 315,000 units in November, a seven month high.
- Istat, the national statistics institute of Italy, reports the country’s consumer confidence index declined to a reading of 91.6 in December from a level of 96.1 in November, citing the introduction of new austerity measures intensifying households’ concerns about a looming economic downturn
- The International Monetary fund (IMF) forecasts Canada will generate about \$51,147 of gross domestic product (GDP) on a per capita basis in 2011, compared with about \$48,147 per capita in the United States. (The figures are quoted in U.S. dollars and are unadjusted for inflation). If the IMF forecasts prove correct, it will mark the first time that Canada has outperformed the U.S. in GDP per person in records dating back to 1980.

- Front Page headline, Globe and Mail – “Ottawa Reduces Deficit to \$2.2 Billion (CAD) for October. In its most recent fiscal update, Finance Canada reveals the federal government posted a \$2.2 billion (CAD) deficit in October, compared with a deficit of \$4.1 billion (CAD) in October of 2010. Over the first seven months of the current fiscal year commencing April 1st. the federal deficit totals \$15.4 billion (CAD), down from \$21.5 billion (CAD) in the same period a year ago.
- Front Page Headline, Daily Telegraph U.K. – “ECB’s 489 Billion Euro Loans Buys Valuable Time for Euro Zone Banks. In an interview with Reuters, Scott Bugie, manager of Standard and Poor’s financial institution division, commented: “The ECB’s 3-year refinancing operation was a big deal ... it does not change the fundamental picture but it does buy valuable time. The move in itself will not lead to any improvement in the banks’ credit ratings ... It’s kicking the can a long way down the road rather than just a little bit, but in the end it is still kicking the big old can down the road.”

**CLOSING LEVELS FOR FRIDAY,  
DECEMBER 23RD. WEEKLY CHANGE**

Dow Jones Industrial Average  
12,294.00 + 427.61 points

Spot Gold Bullion (February)  
\$1,606.00 (U.S.) + \$8.10 per oz.

S&P / TSX Composite  
11,926.67 + 291.29 points

10-Year U.S. Treasury Yield  
2.02% + 17 basis points

Canadian Dollar  
97.96 cents (U.S.) + 1.53 cent

U.S. Dollar Index Future (Spot Price)  
79.994 cents – 0.147 cent

WTI Crude Oil (January)  
\$99.68 (U.S.) + \$6.15 per barrel

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