

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



Monday, July 22nd
Front Page Headline, New York Times / Financial Times – “Detroit Plans to Cut Pensions Amid Cries of Betrayal.”

Monday, July 22nd

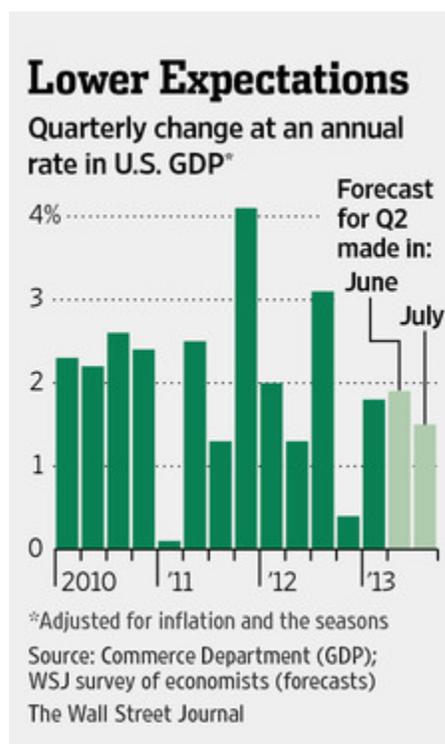
Kevyn Orr, Detroit’s emergency manager, has recommended ‘significant cuts’ to the pensions of current municipal retirees, following the City’s filing of a Chapter 9 bankruptcy petition last week. Mr. Orr’s plan is being vigorously opposed by trade unions who indicate that the City’s pensions are protected by Michigan’s Constitution, which terms them a contractual obligation that ‘shall not be diminished or impaired.’ Detroit’s pension shortfall accounts for about \$3.5 billion (U.S.) of its \$18 billion (U.S.) total debt load. However, Mr. Orr has suggested that Detroit’s pension fund liabilities may be significantly understated because of a combination of unrealistic portfolio valuations and questionable investments. Mr. Orr claims that about 30% of the investments in the general pension fund fall into risky, less transparent categories such as: real estate transactions and development deals in Detroit itself, which lacked sufficient oversight and vetting by professional investment advisors.”



Kevyn Orr (right), Detroit’s emergency manager.

Source: Reuters

- The National Association of Realtors reports U.S. existing home sales declined by 1.2% to an annual pace of 5.08 million units in June, following a 5.18 million unit rate in May, citing higher mortgage rates and reduced inventories of properties valued at less than \$100,000 (U.S.) which historically attract first-time buyers.



- Front Page Headline, Daily Telegraph U.K. – **“EU Crisis States Should Retaliate with a Debtors’ Cartel.** Public debt levels are rocketing (higher) in almost every country within the euro zone periphery. Debt (to gross domestic product) ratios are already crossing the point of no return in Portugal and Italy and nearing the danger zone in Ireland. The latest (debt) figures from Eurostat are shocking even to those who never believed that combined fiscal and monetary contraction – made worse by bank curbs – could have any other result than a faster rise in debt trajectories. Portugal’s debt (level) has just soared through the upper limits set by the EU-IMF Troika, reaching 127.2% of GDP in the 1st. quarter of 2013. This is fifteen percentage points higher than a year ago; the bitter fruit of austerity overkill. The Portuguese people have suffered year after year of (spending) cuts only to find themselves sinking deeper into a debt swamp. Meanwhile, Italy’s debt (to GDP) has hit 130.3% – compared to 123.8% a year ago – rapidly spiraling beyond the safe threshold for a country without its own sovereign currency and central bank. In Ireland, public debt (to GDP) has leaped by 18 percentage points to 125% in a single year. This is partly ‘pre-funding’ to cover borrowing requirements for 2014, but a slide back into recession accounts for a big portion. The former director of the IMF’s team in Ireland, Professor Ashoka Mody, has been urging ‘a complete rethinking’ of the austerity strategy. He confirmed what the Irish trade unions and others have said all along: that fiscal overkill is self-defeating, especially if compounded by tight credit. Professor Mody elaborated: ‘Given the debt dynamics, if debt levels remain where they are and (economic) growth remains where it is, there is never going to be a reduction in the debt (to GDP) ratio in the foreseeable future. Moving away from austerity at this stage is a sensible course of action.’ Certainly, Ireland is not a basket case. It has a decent trade surplus, with exports at 105% of GDP, compared to 30% or less for most of Club Med. It is well able to compete at the current exchange rate. Ireland’s policy of austerity cuts and ‘internal devaluation’ has done wonders for the trade account, but only at the cost of an even deeper debt deflation crisis. This is the fundamental contradiction of European Monetary Union crisis strategy in every high debt country. The more these economies deflate wages, the more they raise the real cost of debt. In Ireland’s case – as in Spain – this debt burden is the legacy of an almighty credit boom that was itself caused by the EMU and years of negative real interest rates. The details are unveiled in a study entitled ‘What Went Wrong in Ireland’ by Patrick Honohan, now central bank governor. Marchel Alexandrovich at Jeffries Fixed Income recently noted: ‘Once debt gets to the 130% (of GDP) level, there

is a risk that the markets will begin to awaken. The moment of truth could come as soon as political stability is called into question in any one of these countries.’ Portugal has been flirting with just such a crisis ever since the finance minister and austerity director, Vitor Gaspar, stormed out three weeks ago. Portuguese bond prices rose today in a brief rally after the country’s president backed down from threats to call a snap election, agreeing instead to allow the crippled coalition of Premier Pedro Passos Coelho to limp on. The yield on 10-year Portuguese bonds fell by 42 basis points to 6.20%, where it was before the constitutional crisis erupted. Yet it is a strange state of affairs when failure to form a ‘national salvation government’ is greeted with delight by the markets. Sovereign debt strategist Nicholas Spiro commented: ‘The politics of economic reform in Portugal have become even more treacherous and it is very unlikely that the political wounds which have been opened can be healed. Mr. Passos Coelho’s authority has now been undermined and aggressive austerity has in any case completely failed. The public debt burden is rising at a frightening pace.’ Last month, the IMF warned that the debt outlook remained ‘very fragile’ and that any external shock could push the country over the edge. It stated that a serious crisis could force the country to assume contingent liabilities and push debt to ‘clearly unsustainable’ levels. Portugal must raise 23% of GDP in funding this year and 22% next year, when it is supposed to access the capital markets again. External debt has reached 230% of GDP. Nominal GDP has contracted over each of the last two years, causing the ‘denominator effect’ to wreak havoc with the debt dynamics. Portugal’s denouement is fraught with risk. Europe’s leaders have made a solemn pledge that they will never again impose haircuts on banks, pension funds and other investors holding EMU sovereign debt, tacitly recognizing that their experiment in Greece was calamitous. So, what will they do when the time comes? Do they impose tangible losses on German, Dutch and French taxpayers for the first time? Does German Finance Minister Wolfgang Schauble ask the Bundestag to write a line into the budget worth 10 billion euros or 15 billion euros marked ‘Losses in Portugal,’ admitting at last that EMU bailouts cost real money? Or, do the creditor states resile from this pledge – as they have resiled from others – and ignite a panic flight from Spanish debt, with instant contagion effects in Italy? Besides, having now imposed the ‘Cyprus template’ of losses on bank depositors above 100,000 euros – as were all bondholders – if lenders get into trouble, how can they hope to contain a systemic banking crisis in Portugal if investors begin to fear that the situation is getting out of hand again? Societe Generale suggests that EU leaders may be tempted, unwisely, to think it is safe to impose private haircuts on the grounds that northern banks have greatly reduced their exposure to these countries. This is how accidents happen. There ought to be a point in this wretched saga when it is clear to the victim states – if it is not clear already – that solidarity rhetoric from the northern powers is contemptible deception, that the North still refuses to accept its joint responsibility for capital and trade imbalances that lie behind the EMU debacle and still refuses to recognize that excess northern savings flooded Club Med, with the complicity of the European Central Bank. There is a condign retort to the creditor cartel. The peoples of Southern Europe could at any time choose to form their own debtors’ cartel and turn the tables. They could confront the creditors with a stern ultimatum. Either you change the entire structure of EMU crisis policy, agree to a reflation strategy and accept your share of the clean-up costs for this collective disaster, or we repudiate our debts. Either you meet us half way, or we take long overdue steps to protect our societies against mass unemployment and to prevent the undermining of our industrial base. The current group of Club Med leaders are too embedded in the EU Project to embrace such an idea and still seemingly persuaded that (economic) recovery is nigh. So, they allow themselves to be picked on one by one by the creditors’ cartel. The current course is untenable. Markets may tolerate EMU debt (to GDP) of 130% for a while, but they are unlikely to tolerate levels nearing 140%, or even any prospect of it. The harsh truth is Europe failed to use the five-year period of largesse created by the U.S. Federal Reserve and the Chinese credit system after the Lehman crisis to resolve its internal mess ... It is time for Southern Europe to look after its own interest once again.”

Tuesday, July 23rd

- The Federal Housing Finance Agency reports U.S. house prices rose by 7.3% through May on a year-over-year basis, citing a reduced inventories and higher mortgage rates.
- Front Page Headline, Bloomberg News – **“Boehner Signals Battle with White House / Senate over Statutory Debt Limit.** In a Washington interview, House Speaker John Boehner (R. Ohio) informed reporters: ‘We’re not going to raise the debt ceiling without real cuts in spending ... Congress needs to determine significant cuts in spending to augment \$1.2 trillion (U.S.) in across-the-board spending cuts over nine years, that took effect on March 1st.’ In addition to spending cuts, Republicans vow they’re determined to reduce benefits in entitlement programs such as Medicare, Medicaid and Social Security. Senate Majority Leader Harry Reid (D. Nev) has already stated: ‘Democrats are not going to compromise on the debt ceiling.’ This issue will likely resurface during the September/October session of Congress, since the American national debt clock has already surpassed the current \$16.7 trillion (U.S.) debt limit, reset last May 19th.

- Front Page Headline, Daily Telegraph U.K. – **Almost 23% of Greeks Live Below Poverty Line.** Citing figures from the Ministry of Finance, the newspaper Ethnos reports 1.1 million Greeks out of 4.8 million workers and pensioners declared an annual income of less than 6,000 euros in 2012, placing them below the poverty line of 7,178 euros.
- Front Page Headline, Financial Post – **“Barrick Gold Sells Energy Subsidiary, Taking \$500 million (U.S.) Loss.** The Toronto-based gold miner has agreed to sell Barrick Energy Inc. to Venturion Oil Limited, White Cap Resources Inc. and Canadian Natural Resources for about \$455 million (U.S.) thereby, realizing a \$500 million (U.S.) loss. Hit by a recent drop in gold prices and cost increases that have plagued miners around the world, Barrick has been inclined to sell non-core assets. The company announced about \$90 million (U.S.) of the \$500 million (U.S.) loss would be a goodwill charge. It has already taken a sizeable impairment charge in the 2nd. quarter – some \$4.5 billion (U.S.) to \$5.5 billion (U.S.) – related to its Pascua-Lama project on the Argentine/Chilean border. Barrick has slowed construction at this massive gold mine, where work was halted by Chilean regulators over environmental violations and must build a new water management infrastructure before resuming operations. The company expects the energy deals to close by July 31st.



A monster truck housed at one of Barrick's open pit gold mines.

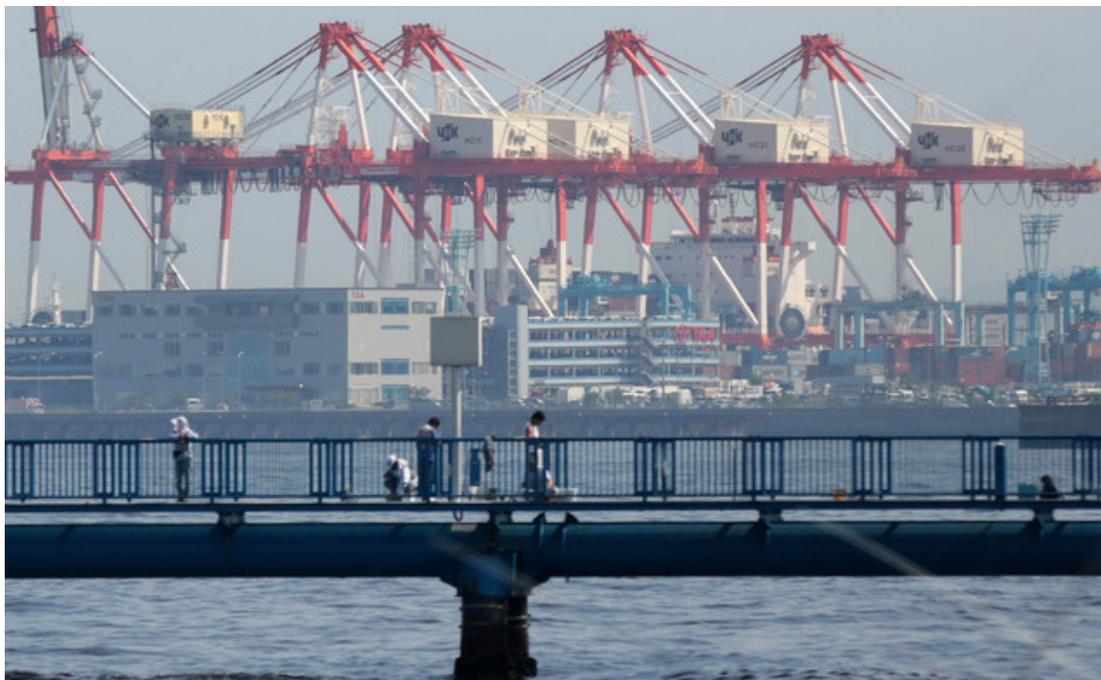
Source: Barrick corporate brochure.

Wednesday, July 24th

- The Commerce Department reports U.S. new home sales rose by 8.4% to an annualized pace of 497,000 units in June – the highest level since May 2008 – citing a low inventory of existing homes and buyer expectations that mortgage rates could rise further.
- HSBC Holdings Plc and Markit Economics report their index for China's manufacturing industry declined to a reading of 47.7 in July and if confirmed with a final reading on August 1st. would be the lowest level in eleven months. Readings below 50 indicate contraction. Interviewed on Bloomberg Television, Qu Hongbin, HSBC's China economist in

Hong Kong stated: “The key factor now is confidence. Business confidence is pretty weak right now in both the financial market and the corporate sector.”

- The Finance Ministry in Tokyo reports Japan’s exports rose for the fourth consecutive month in June – by 7.4% on a year-over-year basis – citing the weak yen enabling products to be more competitive and an increase in shipments to the European Union. While the yen’s decline boosts exports, it also increases Japan’s bill for imports, including the extra energy needed because of nuclear plant closures.



Containers await loading at a shipping terminal in Yokohama City.

Source: Yuriko Nakao / Bloomberg

- London-based Markit Economics reports its euro zone manufacturing index, based upon a survey of purchasing managers, rose to a reading of 50.1 in July from a level of 48.8 in June. Martin van Vliet, an economist at ING Bank NV in Amsterdam, commented: “The monetary stimuli from the European Central Bank ... and the overall slower pace of fiscal austerity have finally managed to curtail the economic contraction.” Separately, Markit Economics reports its preliminary index of U.S. manufacturing for July rose to a reading of 53.2 from a final reading of 51.9 in June.
- Front Page Headline, Daily Telegraph U.K. – **“American Dream in Danger of Becoming a Myth: President Obama.** In a speech delivered at Knox College in Galesburg, Illinois, U.S. President Barack Obama criticized Republicans for stifling America’s economic recovery. The President noted that America’s struggling middle classes had barely seen any increase in their incomes over the last decade and ‘upward mobility’ is becoming more and more difficult to achieve. Citing Congressional gridlock over key measures such as immigration, tax reform and the continued failure to invest in education and infrastructure, the President accused the Republican-controlled House of Representatives of staging an ‘endless display of distractions’ when it should have been taking action to support economic growth. President Obama warned: ‘If the country continues to muddle along, then the American dream of betterment – our founding precept about wide-open opportunity for each generation to fare better than the last – will be a myth, not a reality. If that’s our choice – if we just stand by and do nothing in the face of immense change – understand that an essential part of our (national) character will be lost. Nearly all of the income gains of the past 10 years have continued to flow to the top 1%. The average CEO has received a raise of nearly 40% since 2009, but the average American earns less than he or she did in 1999. I urge Congress to shake off its complacency and set aside the kind of slash-and-burn partisanship we’ve witnessed these past few years.’ According to an NBC / Wall Street Journal poll, U.S. public approval for the Congress has declined to an all-time low of 17%; while President Obama’s own approval rating has fallen to 45% this month, down from 48% in June.”



U.S. President Barack Obama at Knox College.

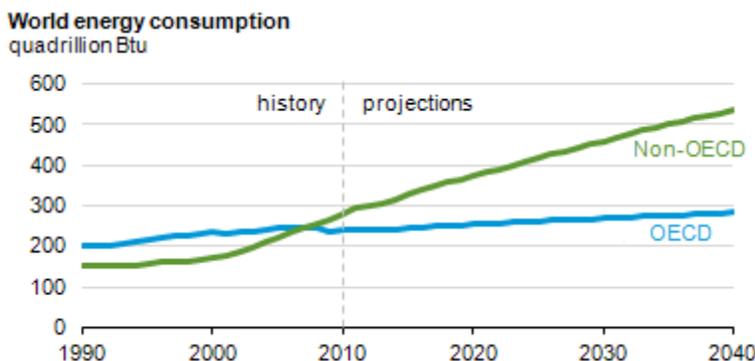
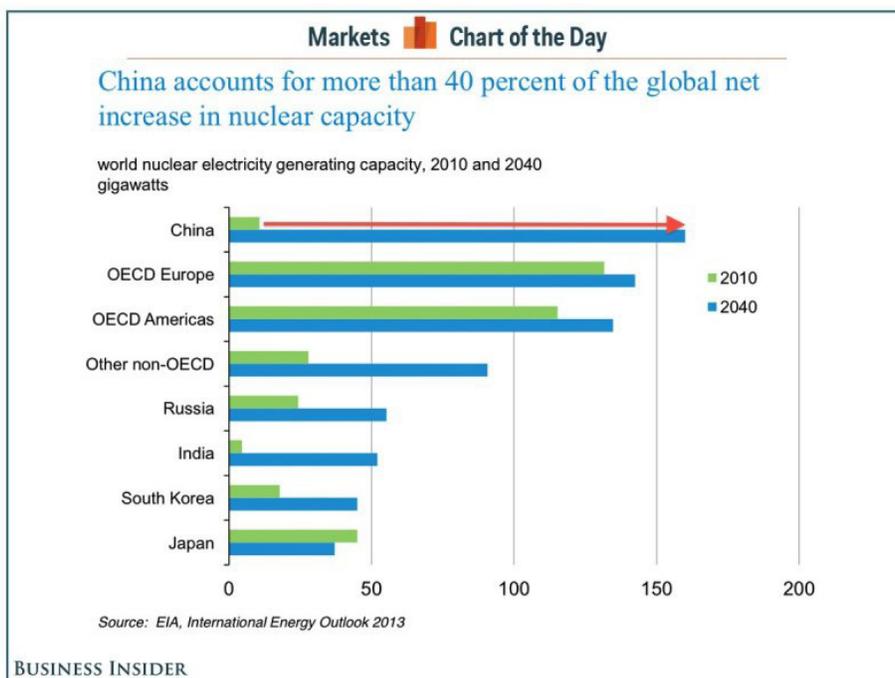
Source: Washington Post

Thursday, July 25th

- The Labor Department reports U.S. initial claims for state unemployment benefits increased by 7,000 to 343,000 in the week ended July 20th. from a revised 336,000 the previous week; while continuing claims declined by 119,000 to about 3 million in the week ended July 13th. Those people who have exhausted their traditional benefits and are now receiving emergency or extended benefits from state or federal programs declined by about 21,300 to 1.62 million in the week ended July 6th.
- London-based Markit Economics reports the composite purchasing managers' index (PMI) for the euro zone rose to an 18-month high reading of 50.4 in July. Separately, the European Commission reports its preliminary measure of consumer confidence for the European Monetary Union (EMU) rose to a reading of minus 17.4 in July, from a level of minus 18.8 in June; its highest level since August 2011.



- The Commerce Department reports U.S. durable goods – those products intended to last for at least three years – orders rose by 4.2% in June, citing higher demand for aircraft and automobiles, following an upwardly revised gain of 5.2% in May. David Sloan, an economist at 4Cast Inc. in New York noted: ‘The manufacturing sector seems to be growing, but not particularly strongly. While it’s a fairly positive (durable goods orders) report, it is not broadly-based.’
- Front Page Headline, Financial Times – **“U.S. Files Criminal Charges Against SAC.** Federal prosecutors file criminal charges against SAC Capital Advisors LP, accusing the giant hedge fund of ‘allowing offences by numerous employees that encouraged systemic insider trading for eleven years.’ The criminal indictment details an expansive scheme alleging founder Steven Cohen incentivized employees to relay ‘high conviction’ ideas to give the fund manager ‘an edge’ over other investors. SAC was charged with one count of wire fraud and four counts of securities fraud. Prosecutors are seeking the forfeiture of about \$10 billion (U.S.) in allegedly illegal profits. The government indictment alleges the fraud was ‘substantial, pervasive and on a scale without known precedent in the hedge fund industry.’
- Front Page Headline, EIA International Energy Outlook 2013 - **“EIA Projects World Energy Consumption Will Increase 56% by 2040.** The U.S. Energy Information Association in Washington releases its International Energy Outlook 2013, projecting that world energy consumption will grow 56% between 2010 and 2040; from 425 quadrillion British thermal units (BTU) to 820 quadrillion BTU. Most of this (energy) growth will emanate from non-OECD (Organization for Economic Cooperation and Development) countries, where demand is driven by strong economic growth.”



- Spain's national statistics bureau INE reports the country's unemployment rate declined to 26.3% in the 2nd. quarter from 27.2% in the 1st. quarter, citing some 5.98 million people remain out of work. Raj Badiani, an economist with IHS Global Insight, commented: "The huge job losses since the housing bubble burst in 2008, suggest that Spain lacks the tools to break free from the recessionary spiral. There is an increasing risk that the (economic) downturn has evolved (into) depression-like characteristics."
- The Office for National Statistics reports the U.K. gross domestic product (GDP) expanded by 0.6% in the 2nd. quarter – following the 1st. quarter's growth of 0.3% – citing every sector, from agriculture to services, made a positive contribution to GDP growth for the first time since the 3rd. quarter of 2010.

Friday, July 26th

- Thomson Reuters/University of Michigan report their final index of consumer sentiment rose to a reading of 85.1 in July from a level of 84.1 in June, citing income and job growth helped bolster consumer buying attitudes, especially for big items such as cars and houses.
- Finance Canada reports the federal government posted a \$2.7 billion (CAD) deficit in the April-May period of the current fiscal year which began April 1st. – \$900 million (CAD) higher than in the same period of 2012. In a research note, Sonya Gulati, an economist at TD Economics, commented: "At this point, we do not have a sufficient number of economic indicators for the 2nd. quarter to gauge whether 2013 government planning assumptions remain on track."
- Front Page Headline, Washington Post – **"White House Hardens Position on Budget Cuts.** According to Democrats close to the administration, senior White House officials are discussing a budget strategy which could lead to a government shutdown, if Republicans continue to demand deeper spending cuts. President Obama's position represents a more confrontational approach than that of last spring when he decided not to escalate a fight over across-the-board spending reductions known as the sequestration, in a previous budget battle with Republicans. The change in tone has been evident in repeated and little-noticed veto threats over the past few weeks by the President, who has rarely issued the warnings with such frequency. President Obama has made it clear that he will not sign into law Republican spending bills that slash domestic programs even more deeply than the sequestration. If Republicans do not relent and the White House stands firm on its position, a government shutdown would be likely at the end of September, when Congress must authorize a higher statutory debt limit – currently \$16.7 trillion (U.S.) – in order to fund the federal government."

CLOSING LEVELS FOR FRIDAY, July 26th

WEEKLY CHANGE

Dow Jones Industrial Average	15,558.83	+ 15.09 points
Spot Gold Bullion (August)	\$1,321.50 (U.S.)	+ \$28.60 per oz.
S&P / TSX Composite	12,647.90	– 37.23 points
10 - Year U.S. Treasury Yield	2.57%	+ 9 basis points
Canadian Dollar	97.29 cents (U.S.)	+ 0.83 cent
U.S. Dollar Index Future (Spot Price)	81.656	– 0.784 cent
WTI Crude Oil (September)	\$104.70 (U.S.)	– \$3.35 per barrel

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