UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

Monday, June 17th

Front Page Headline, Globe and Mail – "Ontario / Quebec Can Manage Significant Debt: Moody's.

Monday, June 17th

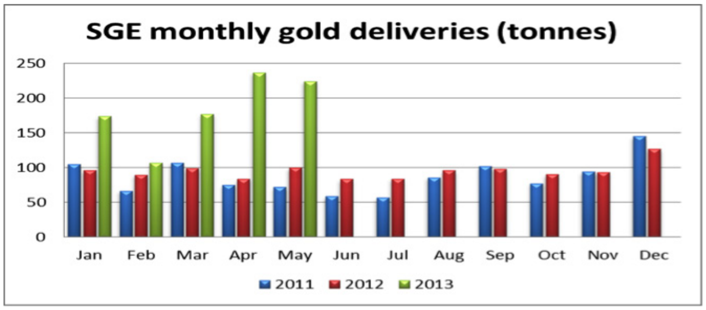
In a new report, Moody's Investors Services argues that the two Canadian provinces' unique fiscal and economic characteristics mean they can carry heavy debt loads, while still enjoying the relatively high credit ratings of Aa2. Moody's, which downgraded Ontario last April, acknowledges: 'While the two provinces' debts are large both in absolute terms and relative to revenues, Ontario and Quebec boast exceptional fiscal flexibility, diverse economies and sophisticated debt management practices.' In an interview, Moody's lead Ontario analyst Jennifer Wong stated: 'The main factor which underpins the high ratings across the provinces is this unfettered access to revenue and expenditure levels."

- The Federal Reserve Bank of New York reports its Empire State manufacturing sentiment index – covering New York State, northern New Jersey and southern Connecticut – rose to a reading of 7.84 in June from a level of minus 1.43 in May, despite a decline in new orders, sales and employment. Ian Shepherdson, chief economist at Pantheon Macroeconomics in White Plains, New York, commented: "The drop in orders is really quite disconcerting. With a bit of luck, there are reasonable grounds this (factory output) will turn around, but at the moment it looks pretty awful."

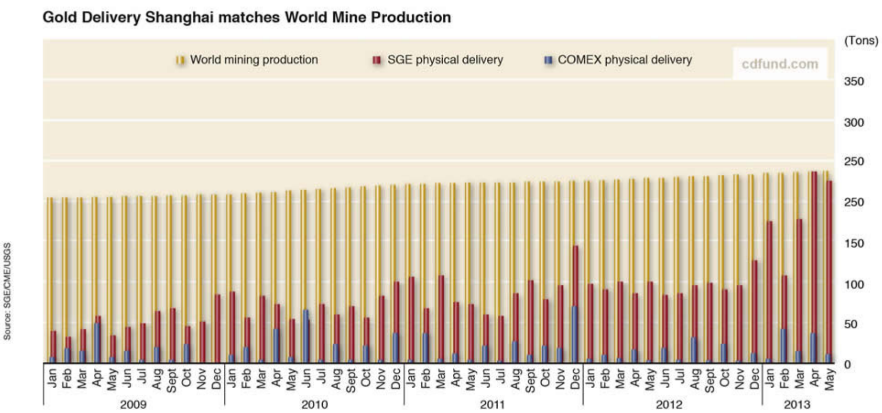
- Front Page Headline, Daily Telegraph U.K. – **"China's Credit Bubble Unprecedented in Modern World History: Fitch.** In a new study, Fitch Ratings reports Chinese wealth products worth $2 trillion (U.S.) of loans are in reality a 'hidden second balance sheet' for banks, allowing them to circumvent loan curbs and avoid efforts by regulators to halt the excesses. Charlene Chu, the agency's senior director in Beijing warns: 'The credit driven growth model is clearly falling apart. This could feed into a massive over capacity problem and potentially, into a Japanese style deflation. There is no transparency in the shadow banking system and systemic risk is rising. Neither do we have any idea who the borrowers and lenders are, nor, what the quality of assets is; so this undermines signaling. Shadow banking comprises over half of all the new credit … A lot of the banking exposure to property is not booked as property. Typically, stress begins in the periphery then moves to the core and that is what we are already seeing with defaults in trust products. The banks have been forced to park over $3 trillion (U.S.) with the Bank of China, giving them a massive savings account which can be drawn down in a crisis; but this may not be enough to avert trouble given the sheer scale of the lending boom. China's overall credit has increased from $9 trillion (U.S.) to $23 trillion (U.S.) since the Lehman Bros. crisis. They have replicated the entire U.S. commercial banking system in five years. The ratio of credit to GDP has jumped by 75 percentage points to 200%. This is beyond anything we have ever seen before in a large economy. We don't know how this will play out, but the next six months will be crucial."

- Front Page Headline, Globe and Mail – **"President Putin Sides with Thugs: Prime Minister Harper.** As leaders from the G8 countries began a two-day meeting in Northern Ireland, the recent decision by the United States to arm Syrian rebels has put Syria at the forefront of discussions, thereby opening the door for clashes with Russian President Vladimir Putin, the only G8 leader to support the Syrian regime. Indeed, Canadian Prime Minister Stephen Harper criticized President Putin over his stand in the Syrian conflict noting: 'Mr. Putin and his government are supporting the thugs of the Assad regime for their own reasons that I do not think are justifiable and Mr. Putin knows my view on that.'

- Front Page Headline, GoldMoney – **"Gold Being Supplied by Western Governments.** There has been considerable throughput of gold in western capital markets, with substantial buying on a global basis following the April bullion price correction. The supply could only have originated from two sources: the general public or one or more governments. It is really that simple. Two months later the gold price has only partially recovered, so physical supplies continue to be made available. Physical demand could not have been entirely satisfied by ETF liquidations, confirming that governments must be involved … While western gold investors have been generally stunned following the April price decline, demand from Asia is running at record levels, as illustrated in the chart below which depicts physical gold deliveries on the Shanghai Gold Exchange.



The increase in deliveries for April and May was spectacular, totaling 460.5 tonnes, with the week ending April 26th. alone recording phenomenal deliveries of 117 tonnes. In addition, according to the Economic Times, India imported 142.5 tonnes in April and 162 tonnes in May, compared with an average monthly pace of 86 tonnes in the 1st. quarter. Therefore, these two countries imported 765 tonnes of gold in two months, before considering any unofficial imports or their government purchases in foreign markets. The rest of Asia – from Turkey to Indonesia – would certainly have increased their demand for gold also, as did the western world itself for the physical metal as opposed to paper entitlements."

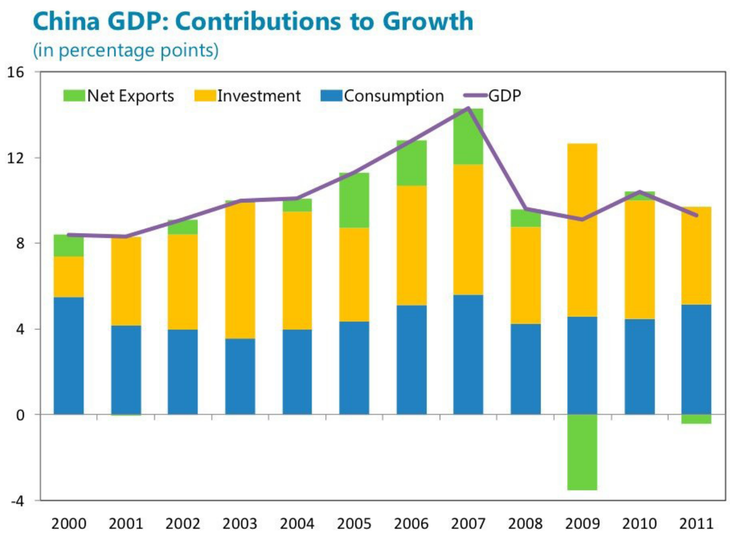


Tuesday, June 18th

- The Labor Department reports the U.S. consumer price index (CPI) rose by 0.1% in May, following a decline of 0.4% in April. Omar Sharif, an economist at RBS Securities in Stamford, Connecticut, commented: "We don't really have an inflation issue in this country. While some Fed officials have expressed concern about inflation, I think the Fed is cognizant of the fact that we're probably at the low readings on inflation."

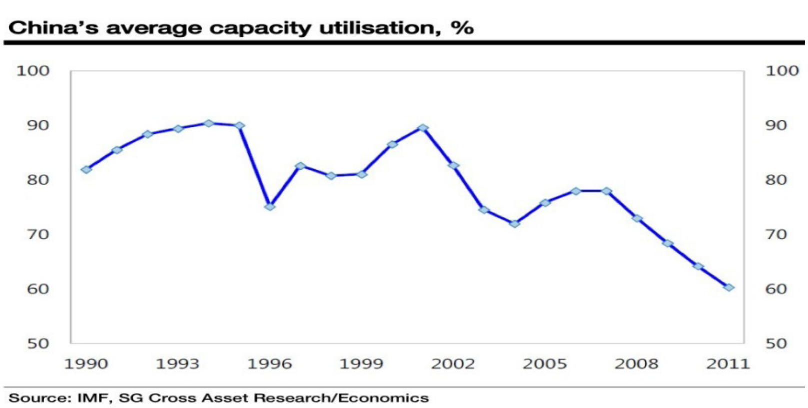
- The Commerce Department reports U.S. housing starts rose by 6.8% in May to an annualized pace of 914,000 units from a revised rate of 856,000 in April, while building permits increased to a 622,000 annual pace, the fastest since May 2008.

- Front Page Headline, Financial Times –**"China's Economic Stimulus Is Coming Home to Roost.** Excess capacity – wherein demand for products is less than potential supply – continues to be one of China's biggest problems. A major contributor to this excess capacity gap is China's investment-led economic growth model. The International Monetary Fund (IMF) chart below illustrates the contribution of investment to gross domestic product (GDP) growth since the year 2000.



Source: IMF

China's massive four trillion yuan stimulus, unleashed after the Lehman crisis, to stem massive unemployment, only worsened the excess capacity problem. In a 2012 note to clients, Pimco's Raja Mukherji wrote: 'China's 2008 economic stimulus programs may have been necessary for stabilization, but they appear to have been too large, too intensively focused on fixed assets and too heavily concentrated on construction. All this stimulus led to massive increases in domestic capacity for steel, cement and aluminum; while demand from export markets fell and property deflated amid financial tightening. As a result, these industries experienced massive excessive capacity.'



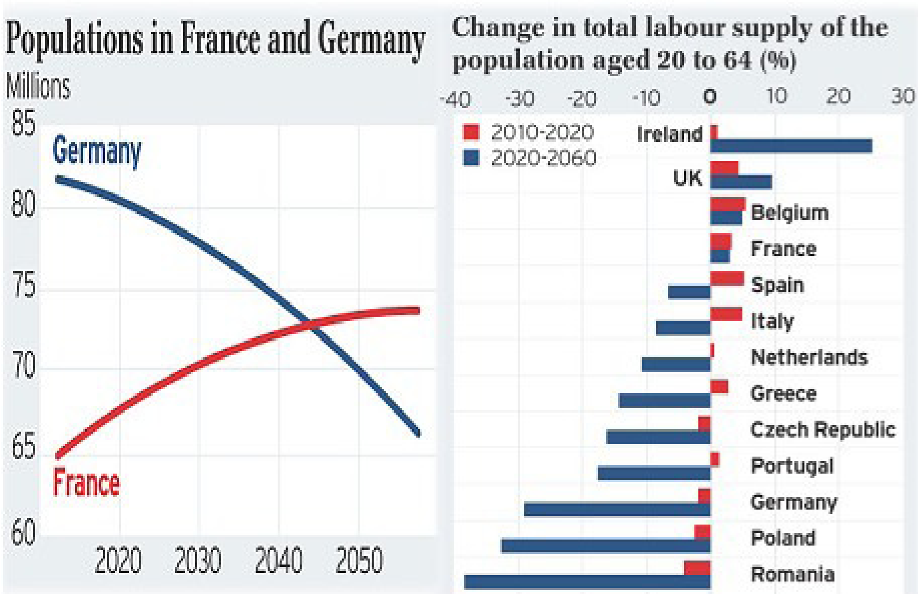
Wednesday, June 19th

- The Finance Ministry reports Japan's exports increased by 10% in May on a year-over-year basis, reflecting about a 12% decline in the yen against the U.S. dollar in the last six months. However, the country still recorded a monthly trade deficit of 993.9 billion yen ($10.4 billion U.S.) – the 11th. consecutive monthly deficit – as the cost of imports increased and nuclear plant closures added to energy demand. Long Hanhua Wang, an economist at the Royal Bank of Scotland Group in Tokyo, commented: "Despite the yen's exchange rate … being lower than last year's level, the volume of exports remains unimpressive since GDP growth in China is stagnating and economic expansion in Europe remains weak."

- Front Page Headline, Bloomberg News – **"FOMC Maintains Q E Status Quo.** Following a two-day meeting in Washington, the Federal Open Market Committee announces it will maintain its current quantitative easing policy of monthly purchases of $85 billion (U.S.) of mortgage-backed securities and U.S. Treasurys, citing 'downside risks to the outlook for the domestic economy and the labor market have diminished. Accordingly, we have raised our GDP growth forecast for 2014 to a range of 3% to 3.5% and lowered our outlook for unemployment to 6.5%. In a press conference, U.S. Federal Reserve Chairman Ben Bernanke stated: 'If the incoming (economic) data are broadly consistent with this forecast, the FOMC currently anticipates that it would be appropriate to moderate the pace of (bond) purchases later this year. If subsequent economic reports meet our expectations, we will continue to reduce the pace of (bond) purchases in measured steps through the first half of next year, ending purchases around mid-year." **At Longwave Analytics we ask the question "Who will replace the Federal Reserve in buying US debt?"**

U.S. Federal Reserve Chairman Bernanke. Source: Globe and Mail

- Front Page Headline, Daily Telegraph U.K. – **'Germany's Ascendancy over Europe Will Prove Short-Lived.** Germany has peaked. Its hegemony in Europe is a power illusion, a confluence of fleeting advantages soon to be overwhelmed by the delayed effect of error and the crush of historic forces. If demography is destiny, it may be clear within five years that ageing Germany is going the way of Japan. Within twenty years it may equally be clear that France and Britain are regaining their 19th. century roles as the two dominant powers of Europe, albeit a diminished prize. The European Commission's 2012 Ageing Report states Germany's population will decline from 82 million to 66 million over the next fifty years due to social structures which cause low fertility, while France increases to 74 million and Britain to 79 million. This is already out of date since the German census revealed in May that the country has 1.5 million fewer inhabitants than previously thought. Since they miscounted foreigners returning home, the total is down to 80.2 million. The German old age dependency ratio will increase from 31% in 2010, to 36% in 2020, with the workforce declining by 200,000 per year this decade. The ratio will climb to 41% in 2025, 48% in 2030 and 57% in 2045. Both the U.K. and France will experience a much milder increase. Germany's EU Commissioner Guenther Oettinger notes: 'Germany is at the high point of its economic output and it will not get any stronger. The country is turning flabby, obsessed with welfare benefits, female quotas, the minimum wage and a no to shale fracking.' Jorg Asmussen, Germany's representative at the European Central Bank, recently lamented the same warning: 'The country risks becoming the sick man of Europe again in five to ten years' if it does not get a grip on infrastructure and education. Germany's top university – Munich Technical – ranks 53rd. in the world, but all of the top 19 universities are Anglo-Saxon.



Source: European Commission

What Germany has is a superb engineering base and an all-conquering automobile industry marketing the premium brands, so much in vogue in China and the Gulf. All effort goes into exports. This trading miracle is married to sclerotic services and swathes of inefficiency at home, again like Japan. Annual productivity per worker grew by just 0.6% from 2000 to 2010, compared with 1.4% for the OECD bloc, lagging so badly that the OECD recommended that Berlin should take lessons from the Australian Productivity Commission. So, there is nothing special about Germany's reforms. It is the business cycle which flatters the profile right now, likewise, as does the wage squeeze that has left Germany with an ultra-European Monetary Union exchange rate undervalued by 30% against the South. That anomaly is why Berlin calls the shots in Berlin today."

Thursday, June 20th

- The New York-based Conference Board reports its index of leading economic indicators rose by 0.1% in May, following an upwardly revised gain of 0.8% in April. In a statement, Ken Goldstein, an economist at the Conference Board commented: "Economic growth will depend upon continued improvement in the housing market and an easing of consumer and business caution, which would allow overall consumption and investment to gain traction."

- The Labor Department reports U.S. initial claims for state unemployment benefits increased by 18,000 to 354,000 in the week ended June 15th. from a revised level of 336,000 while continuing claims declined by 40,000 to 2.95 million in the week ended June 8th. The number of people who have exhausted their traditional claims but are now receiving emergency or extended claims from state or federal programs declined by 19,550 to 1.68 million in the week ended June 1st.

- The Federal Reserve Bank of Philadelphia reports its manufacturing index – covering eastern Pennsylvania, Delaware and southern New Jersey – rose to a reading of 12.5 in June from a level of minus 5.2 in May.

- The Washington-based National Association of Realtors reports U.S. existing home sales rose by 4.2% in May to an annualized pace of 5.18 million units from a 4.97 million unit rate in April, citing low inventories of homes for sale; as well as increasing home values and the threat of rising mortgage rates.

Friday, June 21st

- Front Page Headline, Bloomberg News – **"Rising Bond Yields Risk Debt Spiral: BIS.** In its 83rd. annual report, the Basel-based Bank for International Settlements warns: 'While governments in several major economies currently benefit from historically low funding costs, simultaneously, higher debt levels have increased their exposure to rising interest rates and bond yields. The consolidation requirements of countries experiencing low bond yields would be greater if their GDP growth-adjusted interest rates were to rise. For example, should Japan's age-related government spending continue unaltered, on a 2% increase in funding costs, Japan's public debt would balloon to 600% of gross domestic product by 2050 and America's would almost double to 200%. Adding to pressure on state debt loads are burgeoning 'age-related' expenses. Government liabilities related to health care and pensions as proportion of GDP will rise by 9% in the U.S. between 2013 and 2040, the biggest increase among developed economies. A rise in interest rates without an equal increase in the GDP growth rate will further undermine fiscal sustainability in several major economies. Age-related spending will eventually put debt on an upward path regardless of interest rates or bond yields. However, higher interest rates or bond yields causes debt levels to climb much sooner. According to an International Monetary Fund April forecast, U.S. debt as a percentage of GDP will be 108.1% this year and 109.2% in 2014. This year, the debt to GDP ratio will reach 245.4% in Japan and 93.6% in the U.K."

- Front Page Headline, Globe and Mail – **"Flood Waters Ravage Through Calgary.** The downtown business core of Calgary, Alberta faces indefinite power outages and untold damage next week after devastating flooding made a ghost town out of the city's gleaming array of office towers. With the downtown area under an evacuation order and officials warning that it could be anywhere from days to months before power is fully restores to the business core, some of the biggest oil and gas companies in Canada are preparing to forge ahead using backup systems, satellite offices and telecommuting. However, with the massive Calgary Stampede tourist event in danger of being a washout, thousands of people displaced from their homes and a repair bill potentially in the billions of dollars, there is widespread uncertainty over just how hard the region's and province's economy will be hit and for how long."

Calgary's downtown business core. Source: Globe and Mail

- Front Page Headline, Business Insider – **"Urban Blight Spreads in Gary, Indiana.** NBC News recently profiled the depressed City of Gary, Indiana – just southeast of Chicago at the tip of Lake Michigan – for its Poverty in America series, reporting that about 6,500 of the 7,000 properties the City owns are abandoned; so Gary officials are contemplating auctioning the buildings off for $1 dollar (U.S.) because the City doesn't have the money to demolish them. Gary's deterioration has worsened to the point where officials are also considering the termination of City services to about 40% of the City's land and moving residents to more viable parts of Gary. While this seems like a drastic move, it may become necessary since thousands of abandoned properties are beginning to attract criminals. Gary's economy was basically decimated when the steel industry collapsed. The City has lost 55% of its population since the City's peak in 1960 of 178,320 citizens. By 2010, the population had declined to just 80,294 and in 2012, the U.S. Census Bureau estimated the population at 79,170. In the past, the biggest employer in Gary was U.S. Steel, providing jobs to 25,000 people. Now, only 5,000 work for the company as overseas competition has led to massive layoffs. Gary resembles a ghost town, replete with vacant storefronts downtown, empty sidewalks and boarded-up buildings. A photo below from 2006 illustrates what was once known as the 'City of the Century' in near-ruin."

- Front Page Headline, Daily Telegraph U.K. – **"New Anxieties Erupt in Greece.** The smallest party in Greece's ruling coalition – the Democratic Left – walked out of the Greek parliament in a protest over the abrupt closure of the state broadcaster. The Democratic Left's departure leaves Greek Prime Minister Antonis Samaras with a slim majority. The party has not yet decided whether to offer external support to keep Greece's international bailout on track and its exit could make it more difficult for the government to pass unpopular economic reforms demanded by foreign creditors. Both the International Monetary Fund and the European Commission confirmed that Greece is assured of its next aid payment as long as it forges ahead with its economic reforms."

CLOSING LEVELS FOR FRIDAY, June 21st		WEEKLY CHANGE
Dow Jones Industrial Average	14,799.40	– 270.78 points
Spot Gold Bullion (August)	$1,292.00 (U.S.)	– $95.60 per oz.
S&P / TSX Composite	11,995.66	– 191.70 points
10 - Year U.S. Treasury Yield	2.53%	+ 40 basis points
Canadian Dollar	$95.64 (U.S.)	– 2.7 cents
U.S. Dollar Index Future (Spot Price)	82.410	+ 1.792 cents
WTI Crude Oil (July)	$93.69 (U.S.)	– $4.16 per barrel

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