

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



Monday, August 4th

Front Page Headline, Daily Telegraph U.K. – “France: Frequently Asked Questions about Fiscal Policy. In excerpts from a newly released Global Credit Research report, Moody’s announced: ‘Although the French government (rated Aa1 – negative outlook)

MONDAY, MAY 12TH

Civic Holiday in Canada

has reoriented its fiscal strategy in ways that are broadly positive for the country’s overall competitiveness, the program carries significant implementation risk given its unprecedented scale; the fact that many measures remain undefined, the challenging political environment and the economy’s weak growth. Specifically, the strategy outlines 18 billion euros worth of consolidation measures in 2014 and 50 billion euros between 2015 and 2017. The spending cuts touch every level of government and focus on past sources of expenditure growth; including local government, healthcare and social security. Should these measures be fully implemented, it would be a credit positive. However, Moody’s notes that 60% of the planned expenditure cuts for 2015-17 remain unspecified, a vulnerability that has also been highlighted by the French Court of Audit, the European Union and the International Monetary Fund.’

Moody’s warns that France’s weak gross domestic product (GDP) growth further complicates the execution of the government’s plans. France’s own statistical office is forecasting weaker GDP growth than what is incorporated in the 2014 budget program. Moreover, France’s High Council of Public Finances has expressed concerns about the strength of 2015 GDP growth and considers the 2016 and 2017 GDP forecasts in the Stability Program to be optimistic. Moody’s has recently cut its own GDP growth forecast for France to 0.6% in 2014 and 1.3% in 2015, from 1% and 1.5%, respectively. Overall, Moody’s notes that France’s fiscal performance remains weaker than that of other

Aa1 rated countries, hence its negative outlook and is significantly weaker than Aaa-rated countries. While headline debt and deficit numbers for France and the U.K. (rated Aa1-stable) do not differ greatly at present, Britain has a stronger track record of fiscal consolidation. The U.K. will see its debt burden peak at a lower level than France and has already executed a significant package of expenditure cuts since 2010.”



French President Francois Hollande.

Photo source: EPA files.

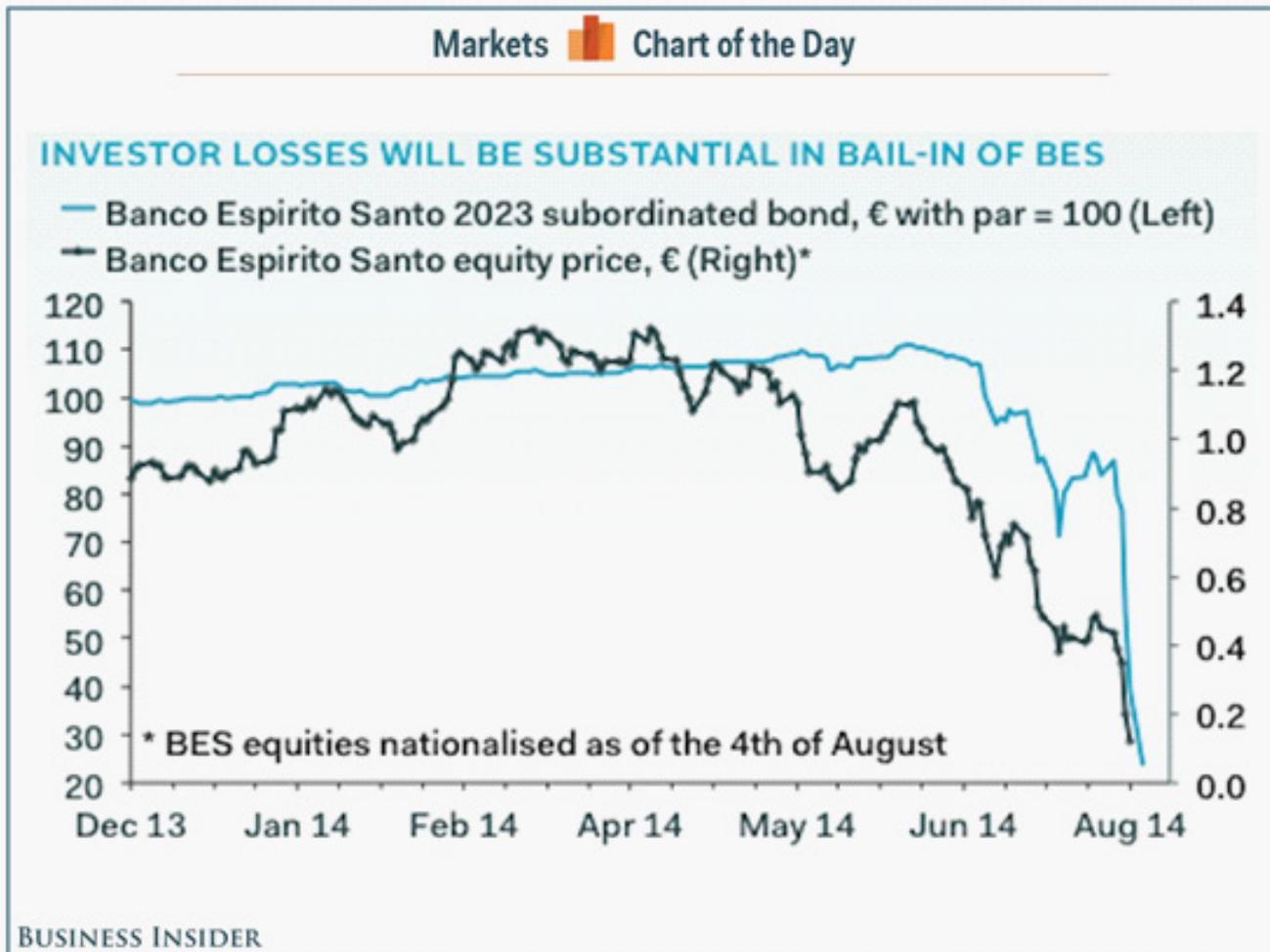
- Front Page Headline, Business Insider – “Investors Will Realize Losses in the Banco Espirito Santo Bail-In. Following a weekend of frenzied discussions between Portuguese and European Union (EU) officials in Lisbon, it was announced that the Bank of Portugal will spend 4.9 billion euros (\$6.58 billion U.S.) to rescue the Banco Espirito Santo (BES) conglomerate by establishing a

new bank, Banco Novo, to whose assets both depositors and holders of senior bond issues will be secured. However, investors holding subordinated bond issues and common shareholders will be secured only by loans made to various entities within the BES banking system, as well as BES' partial ownership in the Angola Bank.

In a note to clients, Holger Schmieding, chief economist at the Berenberg Bank in London, wrote: 'The systemic euro crisis is over. While the euro zone still has issues, it now has a well-oiled machine to deal with them. The vicious contagion risks, which were the hallmark of the euro crisis, can be kept at bay.' Stefan Bongardt, a European banking analyst at Independent Research in Frankfurt, noted: 'While this may not be good for shareholders and unsecured creditors, it's good for the wider banking industry. Now we know the rules of the game and that draws uncertainty out of the market.'

TUESDAY, AUGUST 5TH

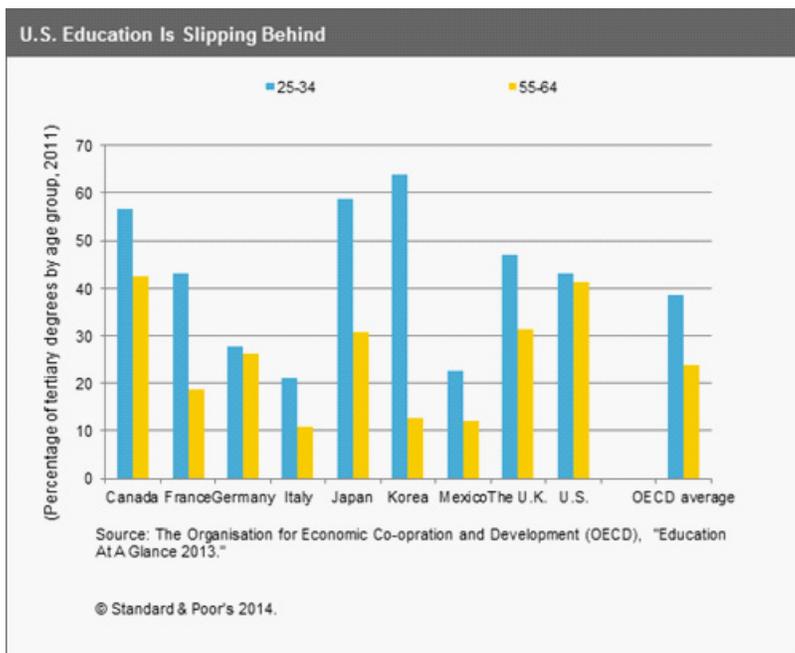
- The Commerce Department reports U.S. factory orders rose by 1.1% in June, following a downwardly revised decline of 0.6% in May, citing higher demand for automobiles, electrical equipment, appliances and computers.
- The Tempe, Arizona-based Institute for Supply Management (ISM) reports its services industry index rose to a reading of 58.7 in July – the highest since December 2005 – following a level of 56.0 in June.



- Front Page Headline, Wall Street Journal – “Increasing Income Inequality Is Dampening U.S. Economic Growth: S&P Study. In a new report, ratings agency Standard and Poor’s outlines: ‘Higher levels of income inequality increase political pressures, discouraging trade, investment and hiring. John Maynard Keynes first showed that income inequality can lead an affluent household to increase savings and decrease consumption, while those of less means increase consumer borrowing in order to sustain consumption, until those options are exhausted. When these imbalances can no longer be sustained, we witness a boom/bust economic cycle. Aside from the extreme economic swings, such income imbalances tend to dampen social mobility and produce a less-educated workforce which can’t compete in a changing global economy. This diminishes future income prospects and potential long-term economic growth, becoming entrenched as political repercussions extend the problems. Alternatively, if we added another year of education to the American workforce from 2014 to 2019, in line with education levels increasing at the rate of educational achievement seen from 1960 to 1965, U.S. potential gross domestic product (GDP) would likely be \$525 billion (U.S.), or 2.4% higher in five years, than in the baseline. If education levels were increasing at the rate they were 15 years ago, the level of potential GDP would be 1% higher, or \$185 billion (U.S.) in five years. Our review of the data, as well as a wealth of research on this matter, leads us to conclude that the current level of income inequality in America is dampening GDP growth, at a time when the world’s biggest economy is struggling to recover from the Great Recession and the government requires funds to support an aging population.”

WEDNESDAY, AUGUST 6TH

- The Commerce Department reports the U.S. trade deficit narrowed by 7% to \$41.5 billion (U.S.) in June, following May’s deficit of \$44.7 billion (U.S.), citing a decline in imports led by automobiles, cellular phones and the lowest petroleum imports in over three years.
- Statistics Canada reports the nation’s trade surplus soared to a 21/2 year high of \$1.86 billion (CAD) in June, following an upwardly revised surplus of \$0.58 billion (CAD) in May, led by exports rising by 1.1% to a record \$45.2 billion (CAD) of metal and non-metallic mineral products, consumer goods and energy products. Benjamin Reitzes, an economist at BMO Capital Markets perceived: ‘It looks as though trade is going to add more to GDP growth in the second quarter than previously expected. The rotation to more export-driven GDP growth could finally be gaining traction.’
- Front Page Headline, Business Insider – “The Slow Recovery in Consumer Spending. In a new study, the New York Fed’s Research and Statistics Group updates how sluggish the recovery in personal consumption expenditures (PCE) has been since the financial crisis. Vice President Jonathan McCarthy writes: ‘One contributor to the subdued pace of gross domestic product (GDP) growth in the current economic expansion has been consumer spending. Even though consumption growth has been somewhat stronger in recent quarters, it has still been weak during this economic expansion relative to previous expansions ... remaining well below its pre-recession peak. One explanation is

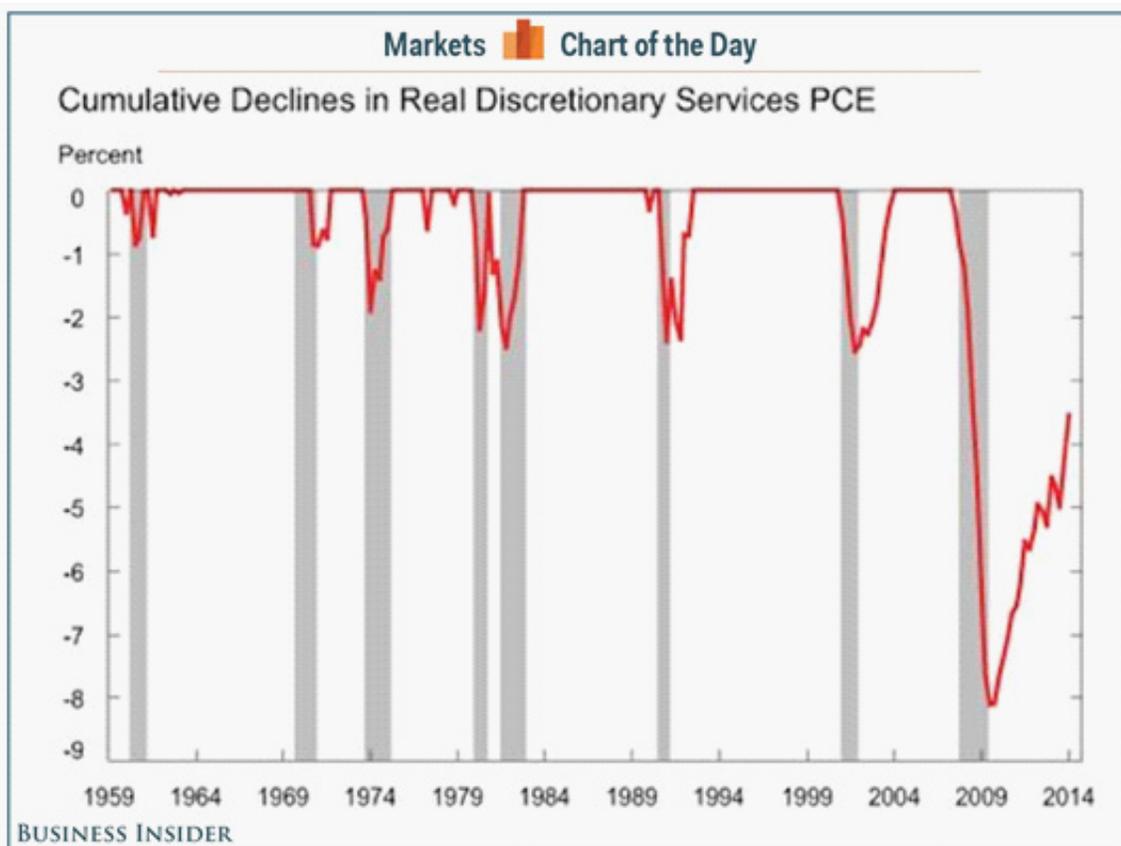


that weak income expectations continue to constrain household spending.

The chart below shows the extent of the decline in real per capita discretionary services expenditures from their previous peak. A zero value in this chart indicates that expenditures are above their previous peak. Although the process has been halting at times, these expenditures have continued to recover from the extraordinary decline (by more than 8% at the trough) during the Great Recession. Specifically, the recovery over 2013:Q4 and 2014:Q1 has been sizeable, moving from about 5% below the previous peak to about 3 1/2%; among the more rapid improvements since 1959. However, it is also evident that the recovery in these PCEs still has a considerable distance to go to return to pre-recession levels. Indeed, 3 1/2% below the previous peak is still considerably worse than the troughs of previous business cycles. Note: In the chart below, data is per capita and PCE is personal consumption expenditures. The shaded areas indicate economic periods designated as recessions by the National Bureau of Economic Research (NBER) in Cambridge, Massachusetts.

THURSDAY, AUGUST 7TH

- The Labor Department reports U.S initial claims for state unemployment benefits declined by 14,000 to 289,000 in the week ended August 2nd, while continuing claims declined by 24,000 to 2.42 million in the week ended July 26th. Thomas Simons, an economist at Jefferies LLC in New York, envisioned: 'If companies have fewer layoffs which provides a necessary precondition for an acceleration in hiring; that should not only, reduce the slack in the labor force, but also, put some upward pressure on wages.'
- The Federal Reserve reports U.S. consumer credit rose by \$17.3 billion (U.S.) in June, following an increase of \$19.6 billion (U.S.) in May. Non-revolving loans, including those for motor vehicles and college tuitions rose by \$16.3 billion (U.S.) in June. Gus Faucher, an economist at PNC Financial Services Group in Pittsburgh, commented: 'Consumers are gradually feeling more comfortable about borrowing, as are lenders about granting new loans. This combination augers well for domestic economic growth.'



- The Economy Ministry in Berlin reports German industrial production, adjusted for seasonal swings, rose by 0.3% in June, following a revised decline of 1.7% in May. Andreas Rees, an economist at UniCredit MIB in Frankfurt, noted: "It's still too early to say that European Union (EU) tensions with Russia are already weighing on hard economic data. However, psychological headwinds are increasing and we'll just have to wait and see whether this pessimism will become persistent." In light of the EU sanctions, Sigmar Gabriel (pictured below), Vice Chancellor of Germany – Russia's biggest trading partner in Europe – last week blocked a project for Rheinmetall AG to build a military training center near Moscow.



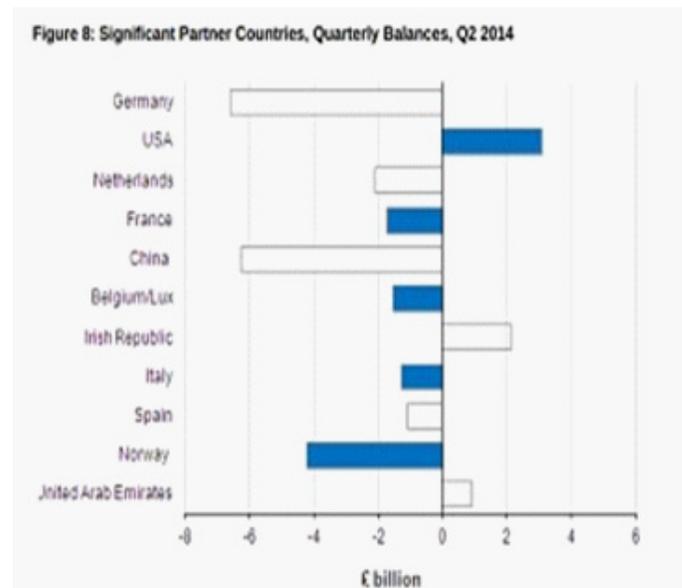
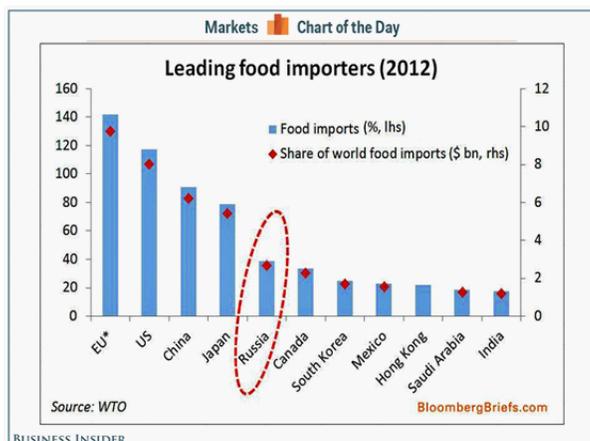
Photo source: Bloomberg

- Front Page Headline, Globe and Mail – "Russia Retaliates by Imposing Food Import Bans against the West. In retaliation for economic sanctions imposed by Western countries, in a statement issued today from the Kremlin, Russian Prime Minister Dmitry Medvedev announced that Russia – the world's fifth largest importer of food products – for a one-year period, will ban fruits, poultry, vegetables, meat, fish, milk and dairy imports from the United States, the European Union, Australia, Canada and Norway."

- Statistics Canada reports the value of Canadian building permits rose by 13.5% in June led by higher construction intentions for medical facilities and information technology buildings in the Province of Quebec; following a 15.5% gain in May.

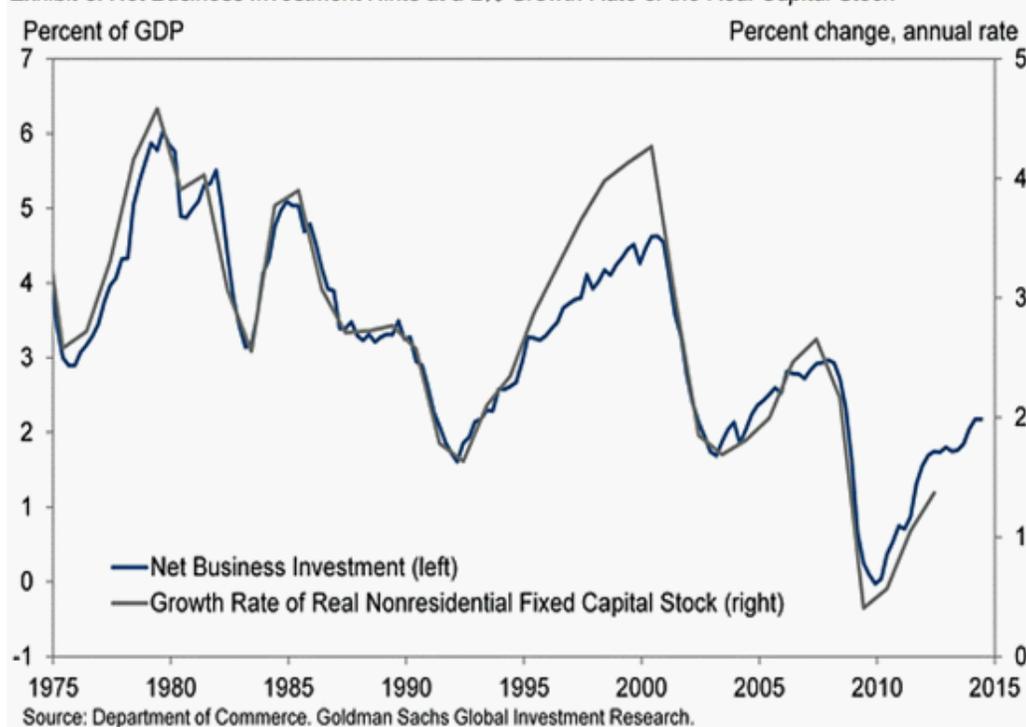
FRIDAY, AUGUST 8TH

- Statistics Canada reports the nation's economy added only 200 full-time jobs in July, as a 60,000 increase in part-time jobs marginally offset 59,700 full-time job layoffs. Statscan estimated there were 17,820,900 people working in July, only 0.7% more than a year ago. The labour participation rate – which measures the percentage of the population either working or seeking work – declined to 69.5%, the lowest level since October 2001. According to the National Bank Financial, employment in Canadian goods-producing industries has declined by 56,000 positions this year, reducing the headcount to its lowest level since January 2012.
- The Office for National Statistics (ONS) reports Britain's trade deficit widened slightly to 2.5 billion pounds in June, as a decline in exports of manufactured goods raised concerns that the strong pound is making it more difficult for U.K. businesses to sell goods abroad. Chris Williamson, chief economist at Markit Economics, warned: "With the stronger exchange rate making imported goods more attractively priced in the U.K., a decline in exports is likely to be accompanied by rising imports, meaning trade could act as drag on the economy in the second half of the year; causing gross domestic product (GDP) growth to slow." See Q2 trade balances in the chart below: Source Daily Telegraph U.K.



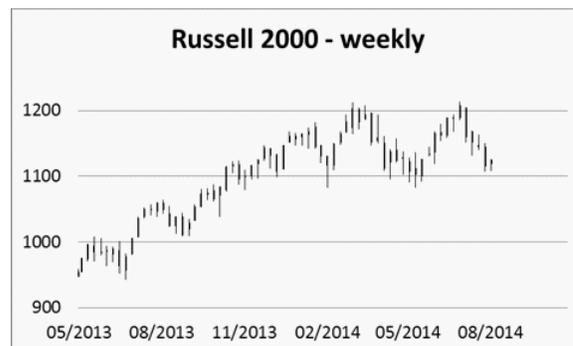
- Front Page Headline, Goldman Sachs – “Investor Hopes for a Big U.S. Business Spending Boom Are Overly Optimistic. In a new research note to clients, Goldman Sachs economist Jan Hatzius argues: ‘Capital spending no longer seems to be at a depressed level because it already appears to be pretty close to equilibrium. If we assume that this remains true in the future, the equilibrium growth rate of the real business capital stock is approximately equal to the potential growth rate of real gross domestic product (GDP) ... At first glance, this observation might still suggest quite a bit of upside for capital spending; after all, the most recently reported growth rate of the real business capital stock is just 1.3%. This is still well below most estimates of potential real GDP growth, which are now clustered in the 2 - 21/4% range. However, the 1.3% capital stock growth rate refers to the 2012 annual average and is now quite dated. Fortunately, we can obtain an approximation of the current growth pace by looking at the ratio of net business fixed investment to nominal GDP. As shown in Exhibit 3, this approximation has historically been quite close. (The only exception is the technology boom of the late 1990s, when unusually rapid relative price changes may have loosened the link between the nominal net investment ratio and the real capital stock growth rate). The relationship currently suggests that the real capital stock is now growing at about 2%. Since this is no longer far below potential GDP growth, it seems that the fundamental argument for big increases in capital spending has weakened considerably.”
- Front Page Headline, Washington Post – “Argentina Warned It Could Face Contempt of Court. U.S. Manhattan District Court Judge Griesa threatened to hold Argentina in contempt of court for continuing to make ‘false and misleading statements’ about its financial crisis. Judge Griesa issued his warning as the State Department indicated that the United States was unlikely to agree to grant jurisdiction to the International Court of Justice in The Hague to hear Argentina’s claims that U.S. Court rulings amount to ‘violations of Argentine sovereignty.’ Argentina had asked the World Court to consider the case. Simultaneously, Judge Griesa urged both Argentina and U.S. hedge fund bondholders to resume negotiations with the special master he assigned to help resolve the dispute. The bondholders are owed about \$1.5 billion (U.S.) which must be paid out before hundreds of millions of dollars in bond payments can be made to other bondholders.”
- The Bureau of Labor Statistics (BLS) reports U.S. unit labor costs (ULC) rose by 0.6% in the 2nd. quarter. As reported by the Business Insider, Dean Maki, an analyst at Barclay’s commented: ‘In the BLS report, there were substantial revisions to data for previous quarters due to the incorporation of the recent annual revisions of the National Income and Product Accounts and which showed slower recent growth in productivity, but faster growth in ULC. For example, the year-over-year growth rate of productivity in Q1 2014 was revised to 0.7% from 1%, while unit

Exhibit 3: Net Business Investment Hints at a 2% Growth Rate of the Real Capital Stock



labor cost growth was revised to 2.6% from 1.2%. In Q2 2014, productivity increased by 1.2% year-over-year, while ULC rose by 1.9%. This BLS release also includes the broadest measure of compensation per hour growth and this increased by 3.1% year-over-year in Q2 2014. All this suggests that compensation is growing faster than narrower measures such as average hourly earnings, or the employment cost index disclose. Overall, we view the rise in compensation and ULC revealed in this report as a modestly positive influence on the core inflation rate in the coming months.

Pantheon Economics analyst Ian Sheperdson notes: "Unit labor costs are up by 1.9% on a year-over-year basis, which seems threatening because inflation can still rise if, as surveys suggest, companies seek to pre-empt higher wage costs by raising prices now."



Simply put, investment is now all about the market trends and little else. One never has to value anything properly any more: just measure confidence. This approach to investing resonates with post-Keynesian economics and government planning. The expectations of the crowd, or its animal spirits, are now there to be managed. No longer is there the seemingly irrational behavior of unfettered markets dominated by independent thinkers. Forward guidance is just the latest manifestation of this policy. It represents the triumph of economic management over the markets. For a long time, central banks have subscribed to the management of expectations. Initially, it was setting administered interest rates in order to accelerate the growth of money and credit. Investors and market traders soon learned that monetary policy is the most important factor in pricing everything. Technical analysis evolved out of credit cycles, which sought to identify market trends and turning points for investment purposes. Today, this control goes much further because of two precedents: the Fed under Alan Greenspan's chairmanship in 2001-02 cut administered interest rates specifically to rescue the stock market out of its slump and secondly, the Fed's rescue of the banking system, in the wake of the Lehman crisis, extended direct intervention into all financial markets.



Original source: Pantheon Economics

- Front Page Headline, GoldMoney.com – "Stock Markets Remain Calm and Soldier On. Researcher Alasdair Macleod cautions: 'At the end of July, global equity bull markets experienced a moment of doubt, falling by 3 or 4%. In the seven trading days leading to August 1st, the S&P 500 declined by 3.8%, but we are not out of the woods yet. During the same time frame, the Russell 2000 – an index of small cap American companies – declined by an exceptional 9%. More worryingly, the Russell 2000 looks like it may have lost its bullish momentum. Indeed, the GoldMoney weekly chart in the next column indicates a possible double-top formation in the making.

Meanwhile, yield spreads on junk bonds widened significantly, sending a signal that the fixed income markets were reconsidering appropriate yield levels for risky bonds. This is conventional analysis and the common backbone of most brokers' reports.

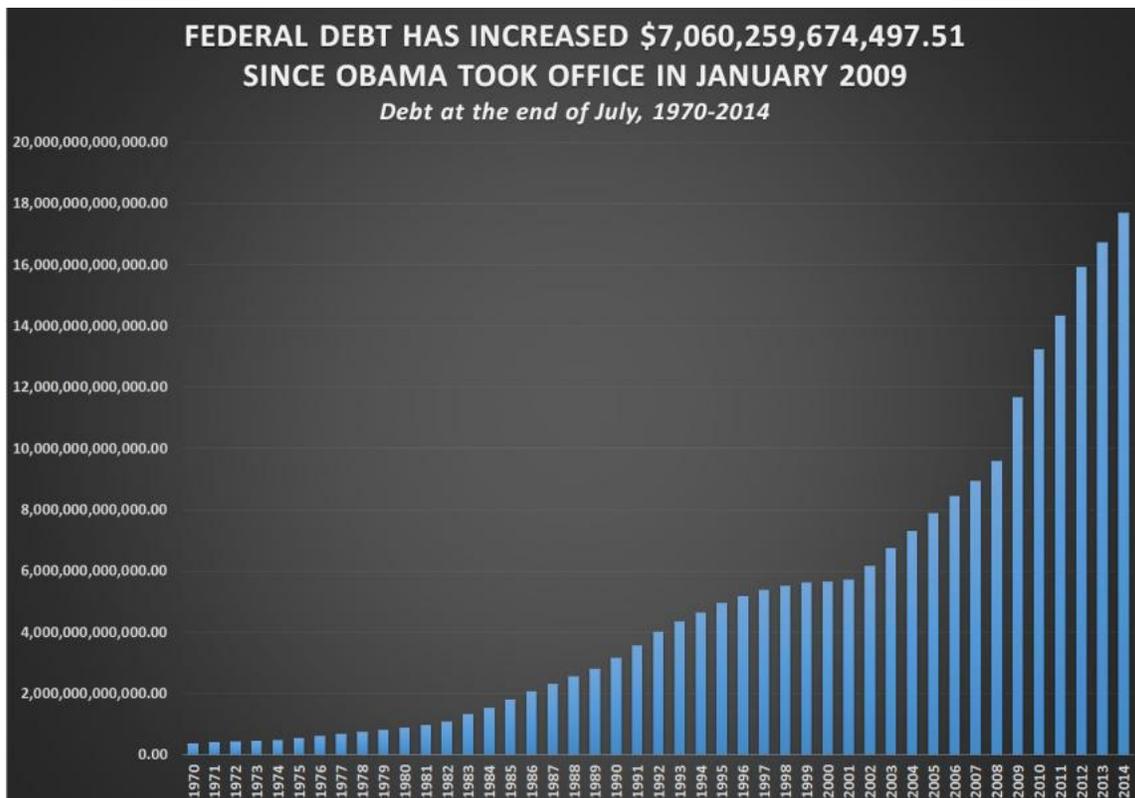
Both of these actions succeeded in their objectives. Ubiquitous Federal Reserve intervention continues to this day and is copied elsewhere. For example, it is no accident that Spanish bond yields are priced as if Spain's sovereign debt is amongst the safest on the planet and as if France's bond yields reflect a credible plan to repay its debt. For many years we have known that via intervention, central banks have managed to control the value of currencies, precious metals and government bonds; but there is increasing evidence of direct buying of other financial assets, including equities. The means for continual price management are present: there are central banks, exchange stabilization funds, sovereign wealth funds and government-controlled pension funds, which among them possess limitless purchasing power. Doubtless, there is a growing band of central bankers who believe that with this control, they have finally discovered

Keynes' Holy Grail: the euthanasia of the rentier and his replacement by the state as the primary source of business capital. This being the case, last month's dip in the stock markets will result in being just that, because intervention will simply continue and if necessary, be ratcheted up. However, in the process all market risk is being transferred from bonds, equities and all other financial assets into currencies themselves; so it will be the outcome of their purchasing power that will prove to be the final judgment in the debate between the markets and economic planning."

- Front Page Headline, CNS News.com – “America’s National Debt \$7.06 Trillion (U.S.) Higher under Obama Administration. In point form:

1. \$7.06 trillion (U.S.) is more than the national debt increased under all U.S. Presidents from George Washington through Bill Clinton combined; plus it is more debt than was accumulated in the first 227 years of America’s existence – from 1776 through 2003.
2. The total national debt first passed the \$7 trillion (U.S.) on January 14, 2004, after President George W. Bush had been in office almost three years.

3. When President Barack Obama took office on January 29, 2009, the total national debt was \$10.6 trillion (U.S.). As of the close of business on July 30, 2014, it had risen to \$17.6 trillion (U.S.) – up by \$7 trillion (U.S.) from Obama’s first inauguration day.
4. According to the U.S. Census Bureau, there were approximately 115 million households in the United States as of June of this year. The \$17.6 trillion (U.S.) in debt the federal government had accumulated as at the end of July equaled about \$153,672 (U.S.) per household.
5. The \$7.06 trillion (U.S.) in new debt which the federal government has amassed during the Obama presidency equals \$61,342 (U.S.) per household. See also: Economic Winter, It’s Still the Debt, Stupid – March 21, 2014.



Source: CNS News.com

CLOSING LEVELS FOR FRIDAY AUGUST 8TH.		WEEKLY CHANGE
Dow Jones Industrial Average	16,553.93	+ 60.56 points
Spot Gold Bullion	\$1,311.00 (U.S.)	+ \$16.20 per oz.
S&P / TSX Composite	15,196.31	– 18.95 points
10 – Year U.S. Treasury Yield	2.42%	– 7 basis points
Canadian Dollar	91.15 cents (U.S.)	– 0.37 cent
U.S. Dollar Index Future	81.398	+ 0.101 cent
WTI Crude Oil Futures	\$97.65 (U.S.)	– \$0.23per barrel

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