Monday July 21st, 2014

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

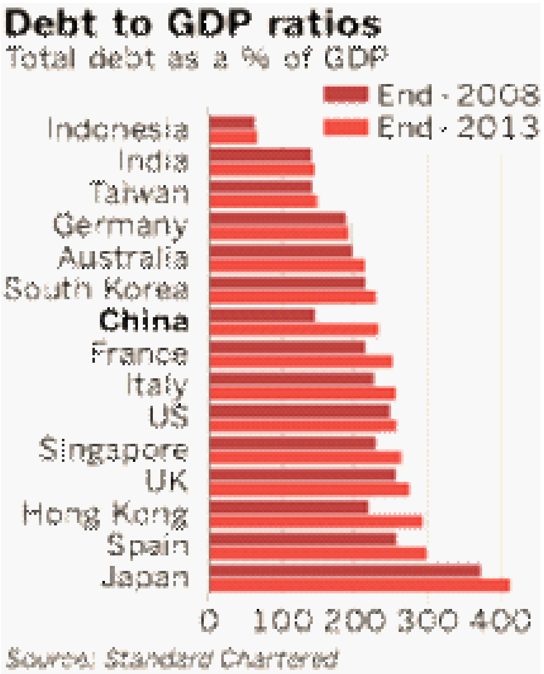
# THAT WAS THE WEEK THAT WAS

Monday, July 21st

Front Page Headline, Financial Times – "China's National Debt Exceeds 250% of GDP. According to a new estimate by Standard Chartered Bank, China's total debt has surpassed 250% of gross domestic product as at June 30th., up from 147% as at

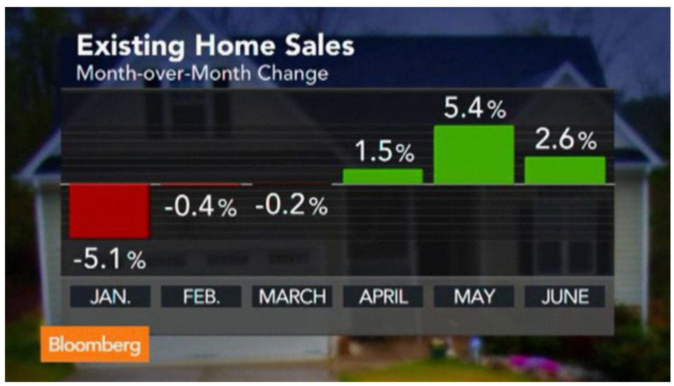
## MONDAY, JULY 21ST

December 31, 2008. Chen Long, an economist at Gavekal Dragonomics – a research advisory – commented: 'China's current level of debt is already very high by emerging market standards and the few economies with higher debt ratios are all high revenue ones. In other words, China has become indebted before it has become rich.' By comparison, the U.S. had a total debt to GDP ratio of about 260% as at the end of 2013, while the U.K.'s ratio stood at 277% and Japan topped the global table at 415%.

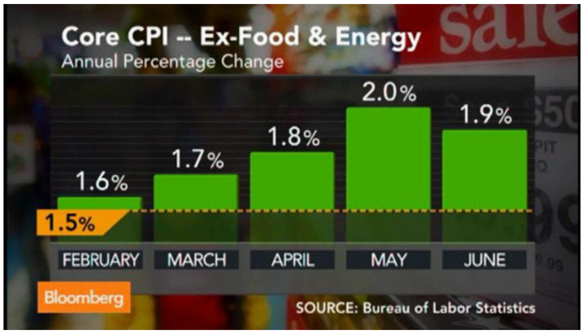



## TUESDAY, JULY 22ND

- The National Association of Realtors (NAR) reports U.S. existing home sales rose by 2.6% to a 5.04 million annual rate in June, following a 4.89 million annual pace in May. Brian Jones, an economist at Societe Generale in New York noted: "The housing market continues its recovery from the winter doldrums, as employment is improving and mortgage rates remain attractive."

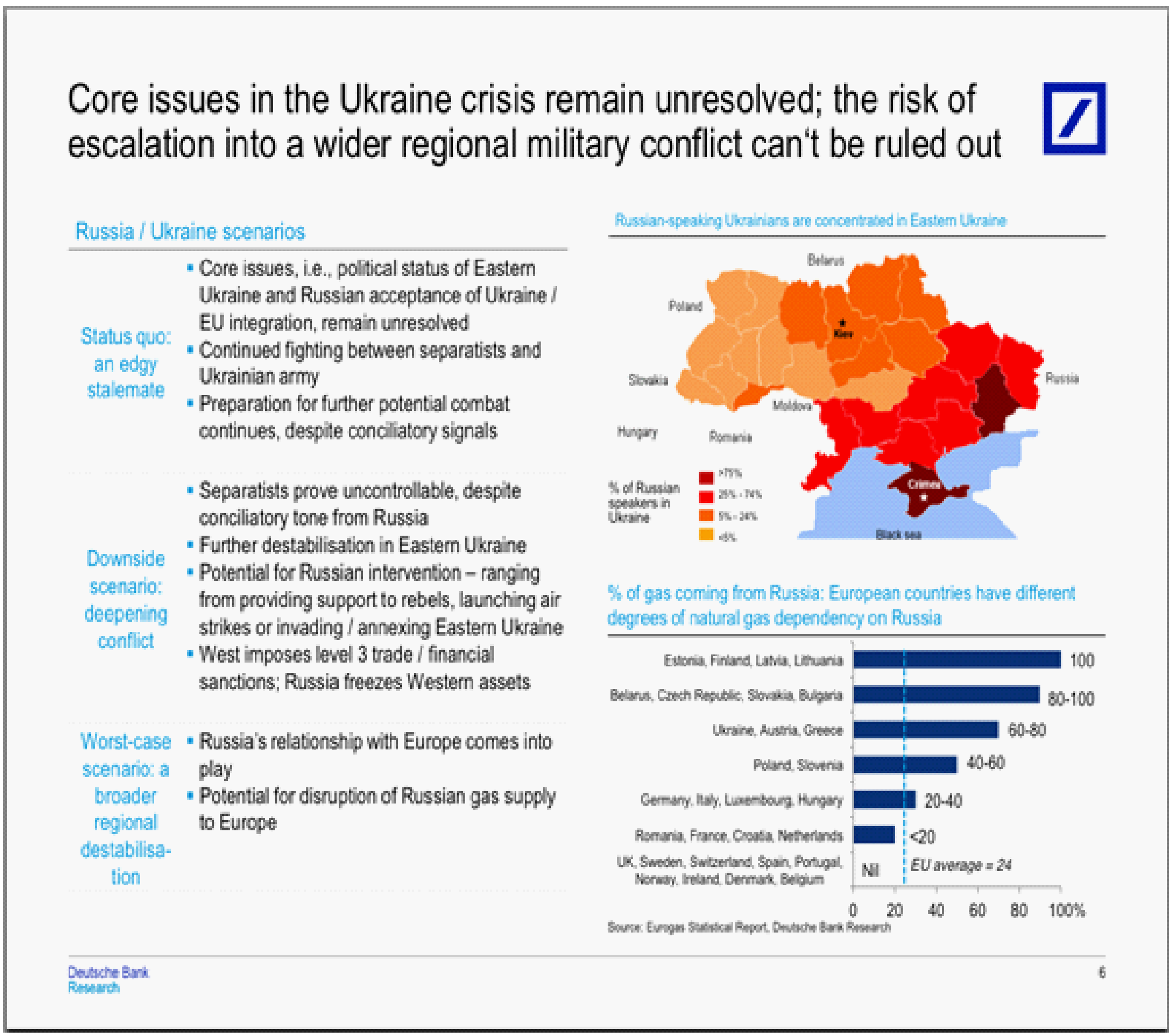



- The Labor Department reports the U.S. consumer price index (CPI) rose by seasonally adjusted 0.3% in June, following a gain of 0.4% in May and by 2.1% on a year-over-year basis. The core rate, which excludes food and fuel costs rose by 0.1% in May and by 1.9% in the same period a year ago.




- Front Page Headline, Business Insider – "Worst Case Scenario for the Russia / Ukraine Conflict: Deutsche Bank.

- Front Page Headline, Daily Telegraph U.K. – "Rocketing National Debt Is Britain's Achilles Heel. In an op-ed, reporter Allister Heath warns: There is a black hole at the heart of Britain's public finances and it is getting bigger. This is happening despite the Great British public being fleeced by the tax man at every turn and Chancellor of the Exchequer George Osborne is desperately seeking to reduce state spending. By this time, the budget ought to be shrinking at an accelerating rate; after all the central economic mission of the coalition government in 2010 was to stave off a fiscal crisis and eventually eliminate the gap between revenues and expenditures.



Instead, the deficit for the first three months of the current fiscal year stood at 36.1 billion pounds, exactly 7.3% higher than the 33.7 billion pounds recorded during the same period last year. Of course, the national debt is continuing to surge, reaching 1.305 trillion pounds in June, equivalent to 77.3% of gross domestic product (GDP). Given that the past three months coincided with a leap forward in economic growth and huge job creation, these figures are shockingly poor. What makes them even more worrying is that the Office for Budget Responsibility is hoping to see the deficit – measured to exclude the impact of financial interventions and the Royal Mail pension transfers – decline by 11.4% for the fiscal year as a whole … The biggest problem stems from the revenue side. For the first three months of the fiscal year, revenues from National Insurance are lower by 0.8%, while receipts from income tax and capital gains tax collapsed by 3.5%. Granted, this was largely the result of one-off distortions; but the results for June alone, while better, remain remarkably subdued given the economy's overall strength …

So, what is going on? Three intriguing trends are worth highlighting. The first is that the economy is probably already at its maximum taxable capacity. It cannot really bear much more as a share of GDP; so the only way that revenues can substantially increase is if Britain's national output also grows. The second related point is that weak wage growth represents one of the main drags on tax revenues. Since productivity is falling, this is the reason why incomes are barely creeping up in cash terms and is actually slumping after accounting for inflation. In turn, this is depressing income tax and National Insurance revenues … Last but not least, it is clear that the Treasury has become desperate. It is squeezing some groups to compensate for the shortfall in other areas and grabbing as much as it can via stealth taxes … Britain need to implement a two-prong strategy. Public spending needs to be reduced further and faster than is currently being planned. Britain also needs pro-economic growth tax reforms designed to boost incentives, capital spending and productivity growth. What is certain is that merely tweaking tax and spend won't be sufficient to dig Britain out of its national fiscal black hole."

- Front Page Headline, Detroit Free Press – "Plan of Adjustment Vote a Major Win for Detroit's Emergency Manager. Detroit has gained its strongest momentum yet for its bankruptcy exit strategy after municipal retirees overwhelmingly backed the City's plan. Both classes of Detroit's pensioners voted heavily in favour of Emergency Manager Kevyn Orr's plan of adjustment, underpinned by the grand bargain which provides $ 816 million (U.S.) to reduce pension cuts, while simultaneously preventing sales of Detroit Institute of Arts masterworks. General city pensioners voted 73% in favour, while 82% of public safety pensioners voted yes for the proposal. However, legal experts warn that Detroit faces significant challenges in the coming weeks, since major financial creditors have pledged to do all they can to convince a judge that the agreement is unfair."

Detroit's Emergency Manager Kevyn Orr.
Photo Source: Associated Press

## WEDNESDAY, JULY 23RD

- Statistics Canada reports the nation's retail sales rose by 0.7% in May to $41.98 billion (CAD) led by strong motor vehicle sales and surpassing April's record retail sales level. Statcan's New Motor Vehicle Sales Survey had reported a record 197,740 vehicles sold in May.

- Front Page Headline, New York Times – "Fed Critical of Deutsche Bank's Oversight and Reporting Efforts in U.S. Jordan Thomas, a lawyer who represents a former Deutsche Bank risk analyst, has revealed that in its domestic regulatory role, the Federal Reserve Bank of New York sent a letter last December to officials at the German bank, directing them to fix problems in the bank's financial reporting procedures, which had existed for several years. The letter coincided with an initiative by U.S. regulators for banks – especially ones based abroad – to be held to the same capital requirements as American banks. The Fed wanted the tougher measures in order to avoid a potential need for future taxpayer bailouts of financial institutions in the event of another financial crisis. In a statement, Michele Allison – a Deutsche Bank spokeswoman – confirmed: "The bank has been working diligently to further strengthen its systems and controls to ensure their being in first-class order. The bank is spending $1.3 billion (U.S.) and employing 1,300 people in support of this effort."

- Front Page Headline, New York Times – "IMF Lowers America's GDP Growth Forecast. In its yearly analysis of the U.S. economy, the International Monetary Fund expects U.S. GDP growth to be only 1.7% in 2014 – a downward revision from a 2% forecast of only a month ago – citing: 'The drag on GDP growth from the 1st. quarter contraction will not be offset." U.S. gross domestic product contracted at a 2.9% annual rate in the 1st. quarter, reflective of a weak housing market, a slower pace of business inventory restocking and lower exports. It was the sharpest quarterly decline in the last five years."

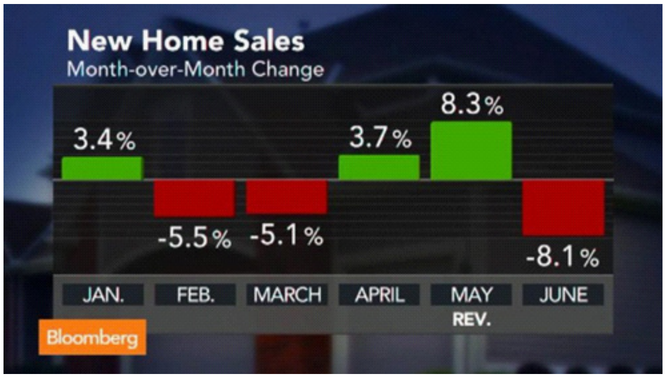
- Front Page Headline, Financial Times – "S&P May Face Fraud Charges Over Six CMBS Ratings. Standard & Poor's – a unit of McGraw Hill – disclosed that it had received a Wells notice from the Securities and Exchange Commission (SEC) indicating its enforcement division staff may recommend authorization of civil charges against the company. While the Wells notice is not a guarantee that the SEC will bring charges, it relates to CMBS sold in 2011. S&P withdrew ratings on a $1.5 billion (U.S.) CMBS issue after discovering inconsistencies in how its rating methodology was applied. That withdrawal prompted an internal review, which highlighted methodology inconsistencies for six other CMBS issues it rated in 2011. In a statement, S&P acknowledged: 'We have been cooperating with the SEC in this matter and our intention is to continue that commitment.'

## THURSDAY, JULY 24TH

- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 19,000 to 284,000 in the week ended July 19th. – an 8-year low – while continuing claims fell by 8,000 to 2.5 million in the week ended July 12th. Tom Porcelli, an economist at RBC Capital Markets in New York, noted: "While the macro employment trend is definitely one of improvement, an asterisk should accompany this number, since revisions are common for claims in July."

- London-based Markit Economics reports the euro area purchasing managers' index (PMI) for the combined manufacturing and services industries rose to a reading of 54 in July from a level of 52.8 in June. This marks the 13th. consecutive month the gauge has exceeded a reading of 50, the level which signals an expansion of activity. Peter Vanden Houte, an economist at ING Groep NV in Brussels, observed: "While the economic recovery has some underlying momentum, there is no reason to become overly optimistic. European Central Bank (ECB) monetary policy must remain extremely accommodative for a protracted period, in order to ensure that the economic recovery can withstand the looming headwinds."

- The Commerce Department reports U.S. new home sales declined by 8.1% in June to an annual pace of 406,000 units, following a 12.3% downwardly revised rate of 442,000 in May. Michelle Meyer, an economist at the Bank of America in New York, commented: "On balance, the housing data has looked weaker than some of the other indicators for the economy. The tightness in credit conditions has limited the pool of prospective buyers."




- Front Page Headline, New York Times – "U.S. Treasury Secretary Lew Urges End to Foreign Tax Flights. U.S. lawmakers have stated they want to stop American companies from reincorporating abroad in order to lower their tax bills; however the Obama administration and Congress appear unlikely to take any action to stem the tide in this regard anytime soon. Last Tuesday, U.S. Treasury Secretary Jack Lew sent letters to the ranking members of the House Ways and Means Committee and Senate Finance Committee, urging Congress to take immediate action to halt the surge of American companies to reincorporate abroad. Yet the wave of so-termed tax inversions looks set to continue unabated, as a partisan Congress remains gridlocked and Wall Street advisors continue to encourage companies to complete such arrangements while they still are able.

  In recent months, several big American companies have reached agreements which will allow them to reincorporate in countries like Ireland and the Netherlands, where corporate taxes are lower. This week alone, two such arrangements appeared sealed, with AbbVie, the drug maker based in Chicago, winning tentative approval from Ireland-based Shire for a $53 billion (U.S.) acquisition and Mylan, the generic drug maker based near Pittsburgh, paying $5.3 billion (U.S.) for the European assets of Abbott Laboratories. In his letter, Mr. Lew suggested: 'Short of undertaking a comprehensive reform of the business tax system, there are concrete steps that Congress can take now which would address this urgent issue.'

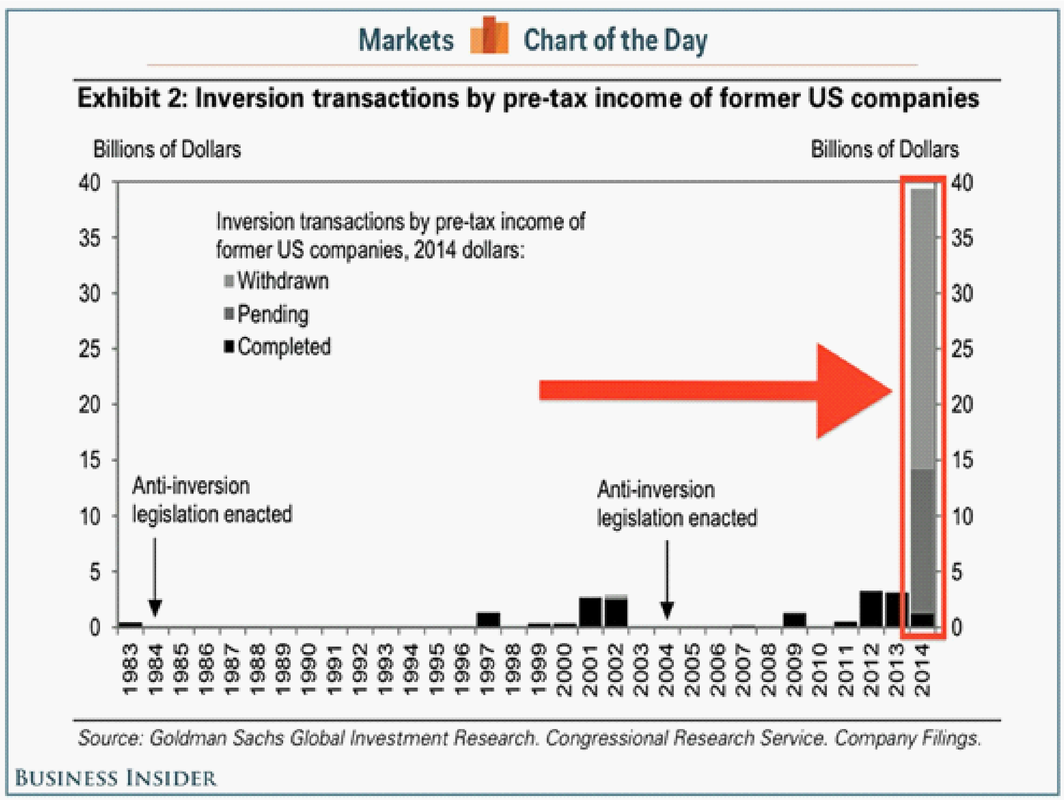
Treasury Secretary Lew elaborated: 'The American firms involved in these transactions still expect to benefit from their business location in the United States, with our protection of intellectual property rights, our support of research and development, our investment climate and our infrastructure; all funded by various levels of government. However, these firms are attempting to avoid paying taxes here, notwithstanding the benefits they gain from being located in the United States."

U.S. Treasury Secretary Jack Lew. Photo source: AP

## FRIDAY, JULY 25TH

- The Commerce Department reports U.S. durable goods – products intended to last for at least three years – orders rose by 0.7% in June, following a slight decline of 0.1% in May.

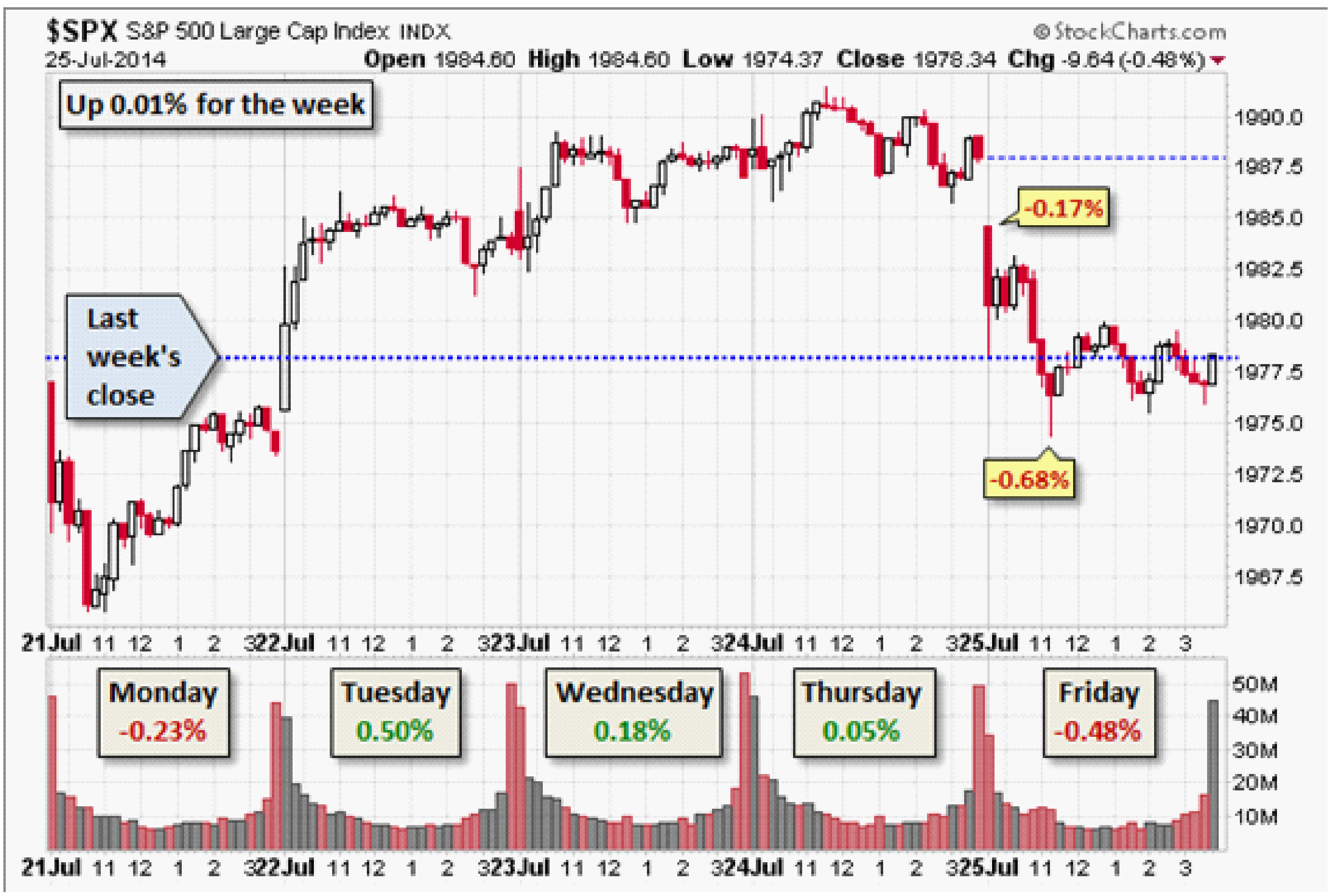

- The Tempe, Arizona-based Institute for Supply Management (ISM) reports its purchasing managers' index (PMI) for the U.S. manufacturing sector declined slightly to a reading of 55.3 in June, following a 5-month high level of 55.4 in May.



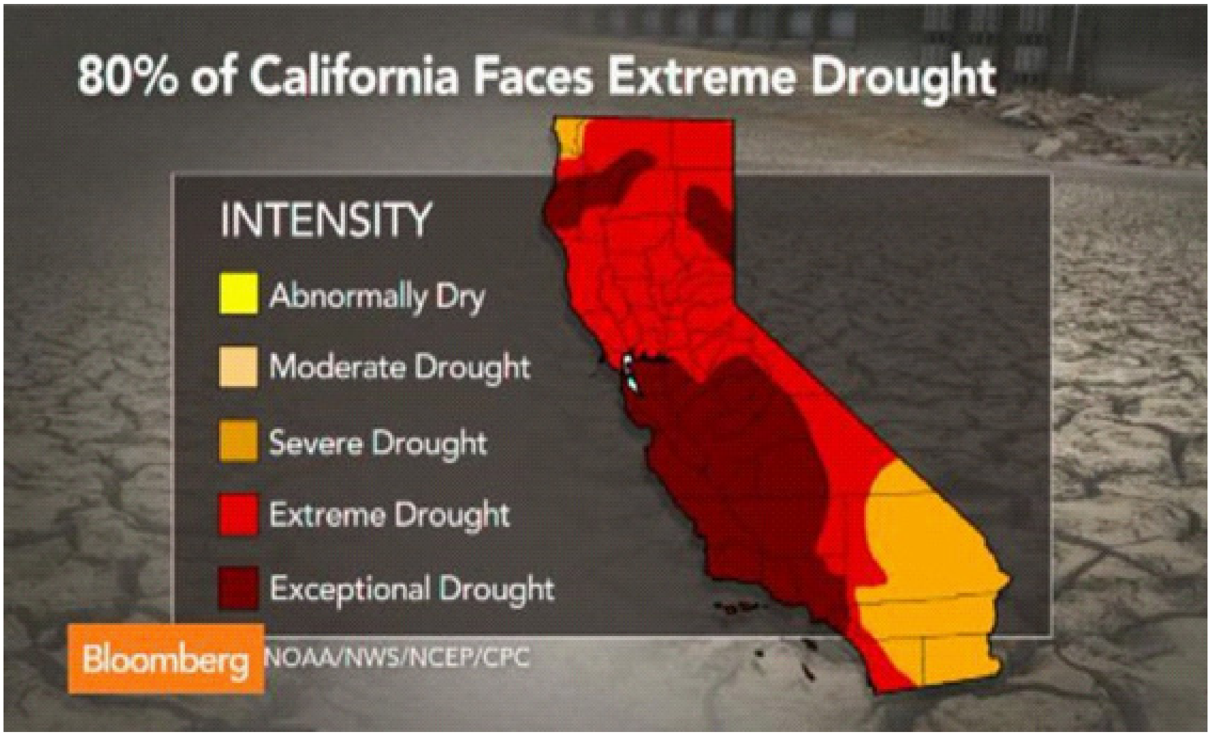
- In its Fiscal Monitor Report for the first two months of fiscal 2015, Finance Canada disclosed the federal government posted a $1.1 billion (CAD) budget deficit in the April – May period, compared to a deficit of $2.7 billion (CAD) recorded in the same time frame a year ago. While the February 11th. federal budget projected a deficit of $2.9 billion (CAD) for 2014-15, that figure includes a $3 billion (CAD) cushion for unforeseen events, such as weaker-than-expected gross domestic product (GDP) growth. Canadian Finance Minister Joe Oliver is expected to release an economic update in the fall, which could see the government's fiscal forecasts revised.

- Front Page Headline, Business Insider – "S&P 500 Basically Unchanged on the Week. Chartist Doug Short of Advisor Perspectives observes: "The S&P 500 set record highs on Wednesday and Thursday, however by week's end the index had gone nowhere. It ended the day with a 0.48% loss and the week with a miniscule 0.01% advance from last Friday's close. The S&P 500 is up by 7.03% year-to-date. Below is a 15-minute chart of the week."

- Front Page Headline, Bloomberg News – "California Drought Worsens. State and local officials in California are struggling to track water usage as Governor Jerry Brown calls for a 20% drop in water consumption to alleviate a record drought. The historic drought has Governor Brown and other officials searching for solutions as they levy fines for over-watering lawns and using a hose without a shut-off valve when washing cars. According to the U.S. drought monitor – a federal website – while 2013 was the driest on record in California, this year 80% of the most populous U.S. state is experiencing extreme drought. Peter Gleick, president of the Pacific Institute – an Oakland-based non-profit organization which advocates for water conservation – acknowledged: 'Despite our longstanding water problems in California, we don't accurately report and measure water in any sector, urban or agricultural. That makes it difficult to implement conservation programs and deal effectively with this water crisis.'




Source: Advisor Perspectives




| CLOSING LEVELS FOR THE WEEK OF JULY 21ST. | | WEEKLY CHANGE |
|---|---|---|
| Dow Jones Industrial Average | 16,960.57 | – 139.61 points |
| Spot Gold Bullion | $1,303.30 (U.S.) | – $6.10 per oz. |
| S&P / TSX Composite | 15,455.04 | + 188.37 points |
| 10 –Year U.S. Treasury Yield | 2.47% | – 1 basis point |
| Canadian Dollar | 92.47 cents (U.S.) | – 0.70 cent |
| U.S. Dollar Index Future | 81.036 | + 0.531 cent |
| WTI Crude Oil Futures | $102.09 (U.S.) | – $1.04 per barrel |

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