Monday July 28th, 2014

LONGWAVE group

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

Monday, July 28th

Front Page Headline, Financial Post – "Lloyds Agrees To Pay $370 million (U.S.) in Fines over Libor Rigging. Lloyd's Banking Group Plc, bailed out by British taxpayers during the financial crisis, will pay 218 million pounds in fines to British and American

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regulators, resultant from manipulating benchmark interest rates, such as the London Interbank Offered Rate. Lloyds will pay $105 million (U.S.) to the Commodity Futures Trading Commission, $86 million (U.S.) to the U.S. Department of Justice and 105 million pounds to the U.K. Financial Conduct Authority. Lloyds has also paid a further 7.8 million pounds in compensation to the Bank of England, since the actions of its traders reduced the fees the central bank received from one of its emergency rescue packages. In a press release, Lloyds Chairman Norman Blackwell stated: 'The actions of those Lloyds' traders between 2006 and 2009 are completely unacceptable. Their behavior involved a gross breach of trust and we condemn it without reservation."

Photo source: Getty Images

- Front Page Headline, Financial Times – "Former Yukos Shareholders Awarded $50 billion (U.S.) in Damages against Russia. By far the biggest compensation award ever made in an arbitration case, a panel in the Permanent Court of Arbitration in The Hague has ruled that Russia destroyed the oil company once primarily owned and operated by jailed oligarch Mikhail Khodorkovsky and expropriated its assets for political purposes. The three-judge court panel – a Canadian, a Swiss and an American – found: 'Yukos was the object of a series of politically motivated attacks by the Russian authorities which eventually led to its destruction. Moscow had aimed to bankrupt Yukos, assign its assets to a state-controlled company and incarcerate Mr. Khodorkovsky who gave signs of becoming a political competitor to Russian President Vladimir Putin."

Russian oligarch Mikhail Khodorkovsky.
Photo source: EPA files.

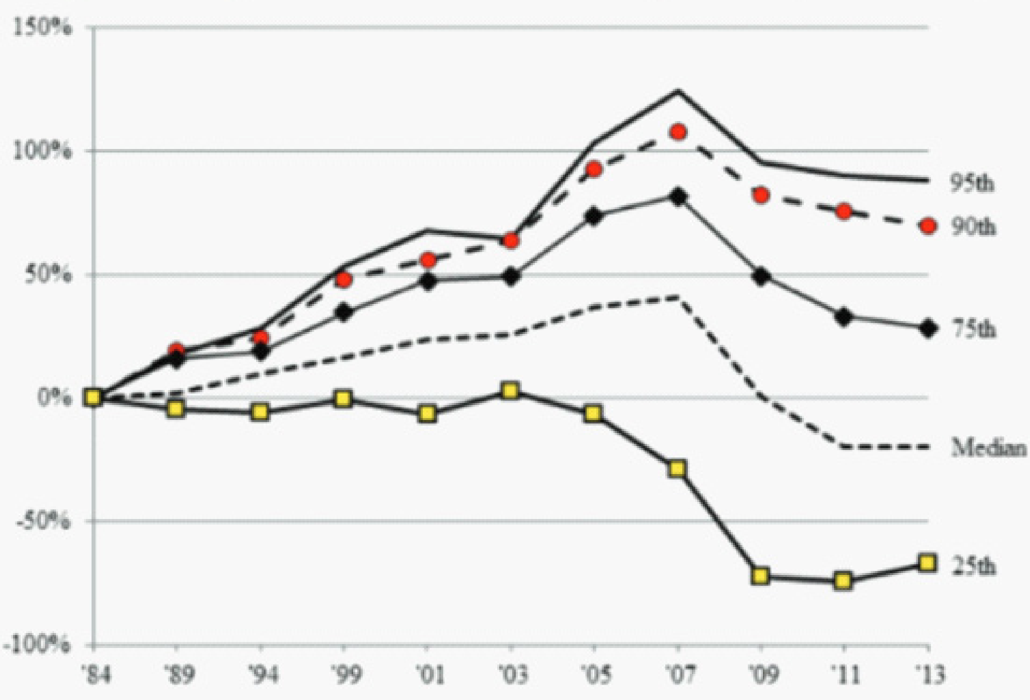
- The Washington-based National Association of Realtors (NAR) reports the index of U.S. pending home sales declined by 1.1% to a seasonally adjusted reading of 102.7 in June from a revised 103.8 level in May. A reading of 100 relates to the average level of contract activity in 2001, or 'historically healthy' home buying traffic. NAR Chief Economist Lawrence Yun commented: 'Inventory shortages still exist in parts of the country, wages are flat and tight mortgage conditions are deterring a number of potential buyers from participating in the housing market during this time.'

- Front Page Headline, David Stockman's Contra Corner – "America's Lost Decade. According to a new study by the Russell Sage Foundation, the inflation adjusted net worth for the typical American household was $87,992 (U.S.) in 2003. Ten years later, it was only $56,335 (U.S.), representing a 36% decline. As the New York Times notes: 'It's not merely an issue of the rich getting richer. The typical American household is getting poorer too.'

The reasons for these declines are complex and controversial, but one point seems clear: When only a few people are winning and more than half the population is losing, surely something is amiss. As the Russell Sage Foundation concludes, through at least 2013 there are very few signs of significant recovery from the loss of wealth experience by American families during the Great Recession. Declines in net worth from 2007 to 2009 were large and the declines continued through 2013. However, these wealth losses were not distributed equally. While large absolute amounts of wealth were destroyed at the top of the wealth distribution, households at the bottom of the wealth distribution lost the largest share of their wealth. As a result, wealth inequality increased significantly from 2003 through 2013; by some metrics, inequality roughly doubled. The American economy has experience rising income and wealth inequality for several decades and there is little evidence that these trends will likely reverse over the near term.

The greatest irony is that President Obama is railing against inequality as one of the most important problems of the day, despite the fact that his policies are squeezing the middle class and causing the Fed – with President Obama's encouragement – to engage in radical monetary policy which is exacerbating inequality. This simple truth cannot be repeated enough."

Figure 1. Change in wealth since 1984 for various percentiles (in 2013 dollars)



Source: Panel Study of Income Dynamics (based on 2013 early release data); calculations by the authors.

- Front Page Headline, GoldMoney – "The Coming Slump." Researcher Alasdair Macleod warns: 'Governments and central banks have made little or, no progress in recovering from the Lehman crisis of six years ago. The problem is not solved by dependence upon statistics which are downright misleading. This is particularly true of real GDP, comprised of nominal GDP deflated by an estimate of price deflation. The idea that there is such a thing as a valid measure of price inflation is only true in an econometrician's imagination. An index which might be theoretically valid at a single point in time is only subsequently valid in the wholly artificial construction of an unchanging, or 'evenly rotating economy' – in other words – an economy where everyone who is employed remains in the same employment position producing at the same rate, retains the same proportion of cash liquidity and buys exactly the same things in the same quantities. Furthermore, business inventory quantities must also be static. All human choice must be excluded for this condition. Only then can any differences in prices be identified as due to the changes in the quantity of money and credit … Furthermore, biases are built into the index for example, to overweight consumer spending relative to capital investment and to incorporate government activity which is provided to users free of cost or subsidized. Purchasing art, equity investments or a house, are as much economic transactions as buying a loaf of bread, but these activities and many like them are specifically excluded. Even worse, adjustments are often made to conceal price increases in index constituents under one pretext or another. Economic activities are also only selectively included in GDP, which is supposed to be the total of a country's transactions over a period of time expressed as a money total. A perfect GDP number would include all economic transactions and in this case, would capture the changes in consumer preferences excluded from a static price index. However, there is no way of identifying them to tell the difference between changes due to economic progress and changes due to monetary inflation.

  Let's assume that in a nation's economy, there is no change in the quantity of money earned, held in cash, borrowed or repaid between two dates. This being the case, what will be the change in GDP? Obviously, the answer is zero. People can make and buy different products and offer and pay for different services at different prices, but if the total amount of money spent is unchanged, there can be no change in GDP. Instead of measuring economic growth, a meaningless term, it only measures the quantity of money spent … It stands to reason that actions based upon wrong assumptions will not achieve the intended result. The assumption is that money-printing and credit expansion are not having an inflationary effect because the statistics confirm same. However, the statistics are selective, focusing on current consumption. Objective inquiry about wider consequences is deterred and nowhere is this truer than when seeking an understanding of the wider effects of monetary inflation. This leads us to the second error: we ignore the fact that monetary inflation is a transfer of wealth from the public to the creators of new money and credit.

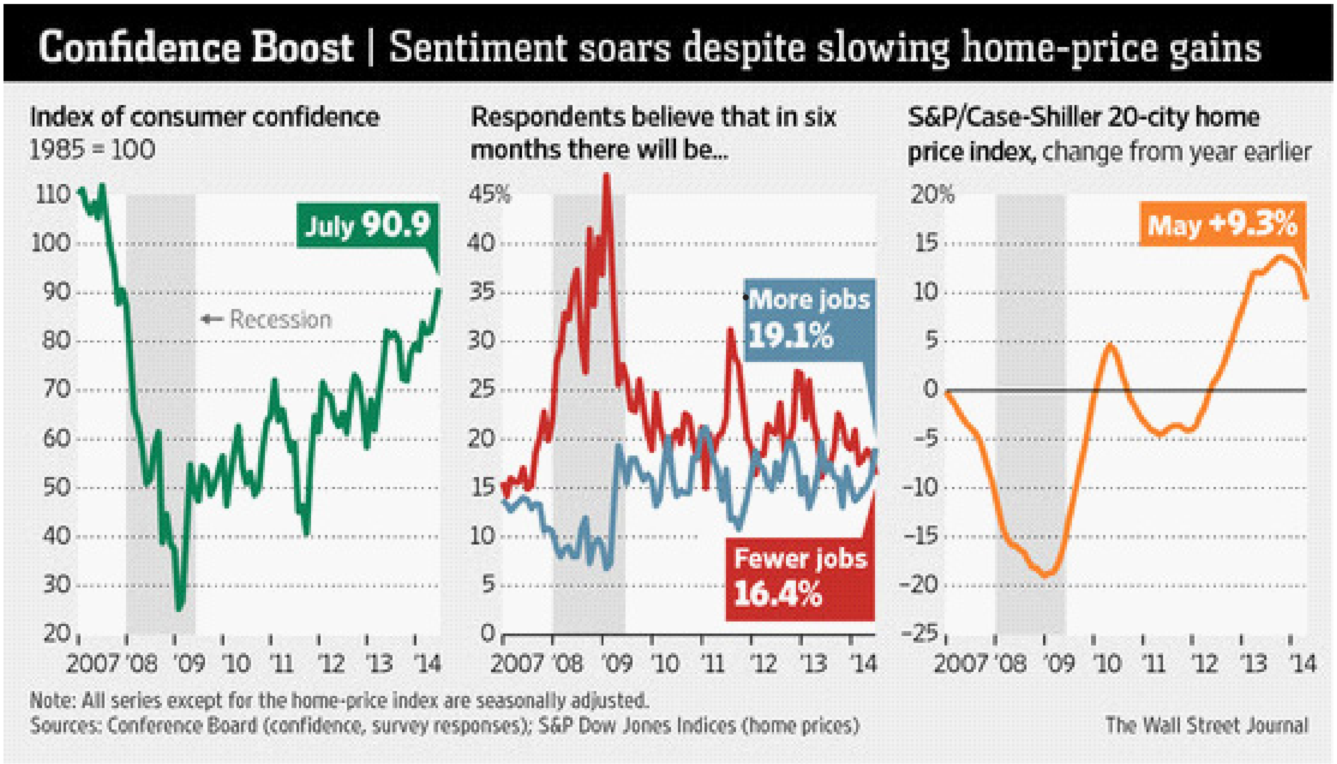
  The transfer of wealth through monetary inflation is initially selective, prior to being distributed more generally. The issuers of new currency and credit are governments and the banks, both of which reap the maximum benefit of utilizing them before any prices rise. However, the ultimate losers are the majority of the population: by the time new money broadens into wider circulation, prices have already risen to reflect its existence. Everywhere, monetary inflation transfers real wealth from ordinary people on fixed salaries, or with savings. For example, since the Lehman crisis in America, money on deposit has increased from $5.4 trillion (U.S.) to $12.9 trillion (U.S.). This gives us an idea of how much the original deposits are being devalued through monetary inflation, a continuing effect gradually revealed through those original deposits' diminishing purchasing power. The scale of wealth transfer from the public to both the government and the commercial banks, which is in addition to visible taxes, is strangling economic activity. The supposed stimulation of an economy by monetary means relies upon sloppy analysis and the ignorance of the losers. Unfortunately, it is a process once initiated is difficult to stop without exposing the true weakness of government finances and the fragility of the banking systems.

  Governments with the burden of public welfare costs are in a debt trap from which they lack the resolve to escape. The transformation of an economy from no monetary discipline into one based upon sound money principles is widely thought by central bankers to risk creating a major banking crisis. The crisis will indeed come, but it will probably have its origins in the inability of individuals, robbed of the purchasing power of their fixed salaries and savings, to pay the prices demanded from them by businesses. This is called a slump, an old-fashioned term for the simultaneous contraction of production and demand. Not even zero or negative interest rates will save the banks from this increasingly certain event, for a very simple reason: by continuing the transfer of wealth from individuals through monetary inflation, the cure will finally kill the patient. There is a growing certainty in the global economic outlook that is deeply alarming. The welfare-driven nations continue to impoverish their people by debauching their currencies. As Japan's desperate monetary expansion now shows, far from improving her economic outlook, she is moving into a deepening slump, for which this article provides the explanation. Unfortunately, we are all on the path to the same destructive process."

TUESDAY, JULY 29TH

- The S&P/Case-Shiller group report while their index of property values for 20 U.S. cities declined slightly by 0.31% in May, it increased by 9.3% on a year-over-year basis. Aneta Markowska, an economist at Societe Generale in New York, noted: "May's index level represents a healthy slowdown for the housing market. The sooner the market corrects to a more sustainable growth rate, the better it is for the price outlook over the medium term."

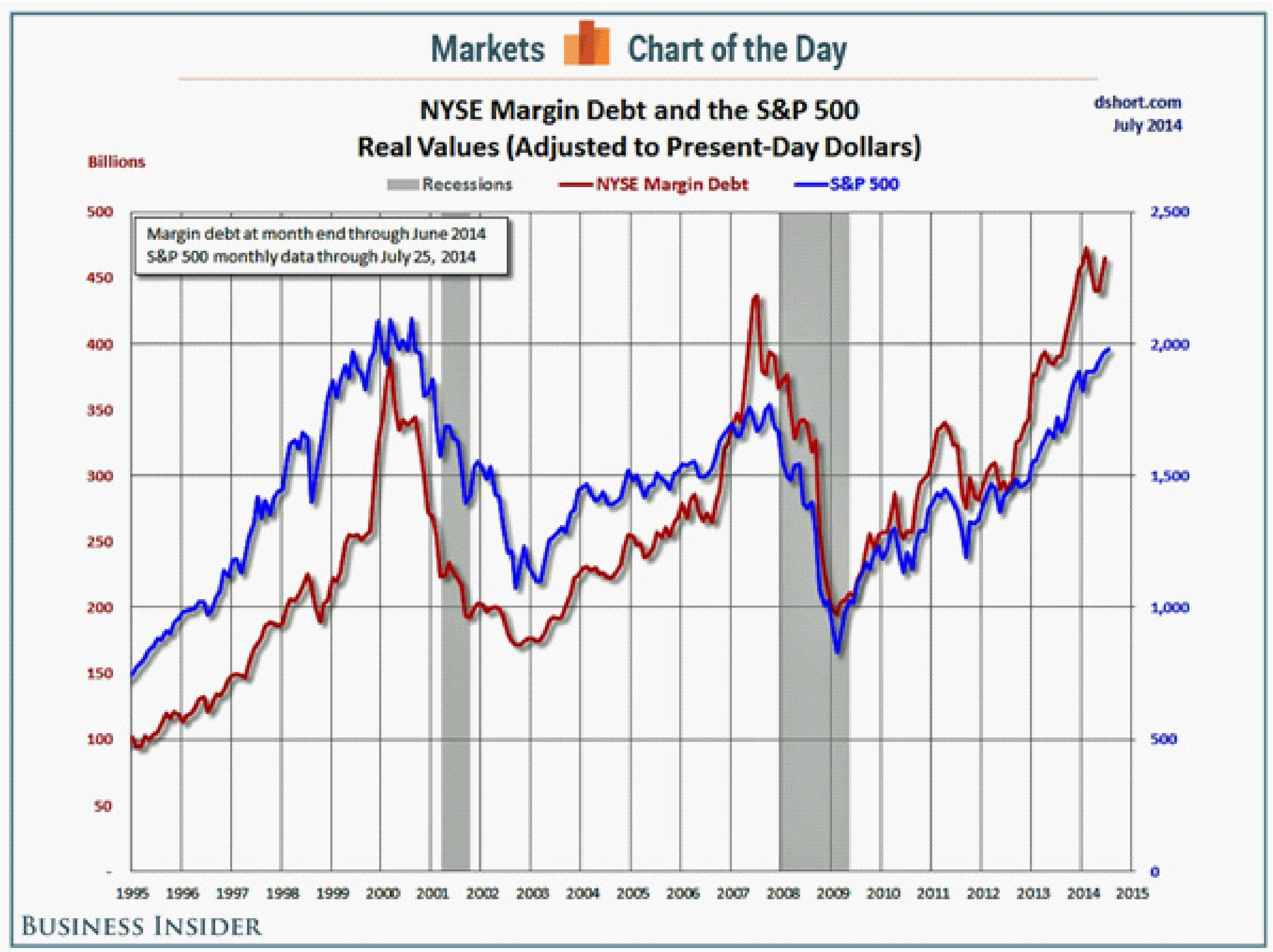
- The Conference Board – a New York-based research group – reports its U.S. consumer confidence index rose to a reading of 90.9 in July, following a level of 86.4 in June; citing improved employment conditions and lower gas prices.



- Front Page Headline, Daily Telegraph U.K. – "British Bankers Brace for PRA Crackdown. Under proposals to be unveiled tomorrow by the Bank of England's Prudential Regulation Authority, top bankers in Britain will become directly accountable for their actions, with those behaving recklessly facing jail. The PRA will also publish final rules on clawing back bonuses paid to bankers found guilty of misconduct; plus consult on closer scrutiny on how awards are made. Bonuses issued to 'code staff' – those who can assume the biggest investment risks at a bank – will be subject to a clawback lasting seven years from when they were awarded …The measures are in response to public anger over having to bail out banks, such as the Royal Bank of Scotland and Lloyds Banking Group during the 2007-09 financial crisis, which saw few individual bankers punished. Parliament also wants to restrain the payment of big bonuses at a time when most people have been forced to tighten their belts, as new scandals emerged in the banking sector. See above, Monday, July 28th. – Lloyds Agrees to Pay $370 Million (U.S.) in Fines over Libor Rigging.

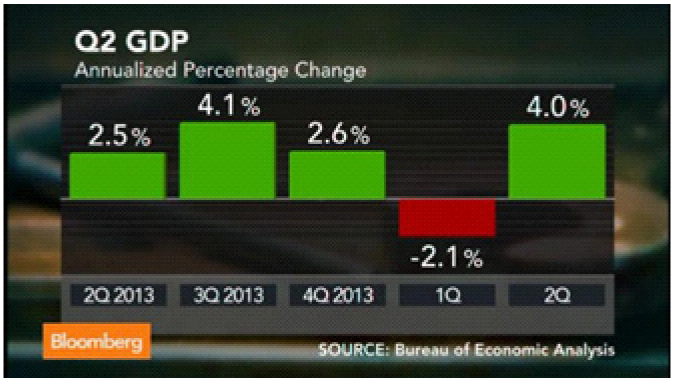
The PRA will also launch a consultation on tougher oversight of top bankers, known as the senior persons regime, as recommended by a parliamentary commission on banking standards. Omar Ali, U.K. liaison for banking and capital markets at the European Union (EU), commented: 'The consultation paper is likely to be a game changer, developing the concepts of reckless mismanagement and the reversal in the burden of proof; as well as the introduction of criminal sanctions. The regime is likely to be the strictest (regulator) of any market or industry.' Under the new regime, bankers could be jailed for up to seven years for reckless misconduct. Top staff would have to prove to regulators that they were not aware of, or had challenged dubious behavior at the time. Senior bankers must sign a statement listing their specific responsibilities, making it easier for regulators to hold them to account if something goes wrong. There will also be consultation on broader remuneration issues. Under European Union law, only a minority portion of a bonus can be paid up front in cash, with the balance deferred over five years and paid in shares which vest over time." See also, Economic Winter – Malfeasance in the Financial Services Industry – July 21, 2014.

- Front Page Headline, Business Insider – "NYSE Margin Debt Is Back in the Scary Zone. Back in March, bond researcher Jeffrey Gundlach was warning that NYSE margin debt, which reflects the dollar volume of equities which investors have purchased on credit, was 'in the scary zone.' At the time, NYSE margin levels had surged to $465 billion (U.S.) and as at the end of June, were threatening those all-time highs again. Long time stock market observer and investor Dennis Gartman writes: 'If the highs were made a few months ago in margin debt, the stock market is now more vulnerable than it was, if history is prologue to the future. According to the U.S. Securities and Exchange Commission (SEC), although past performance by mutual fund and hedge fund managers is not indicative of future performance; when it comes to margin debt, the past truly is a guide to the future.' For his part, Gundlach cautioned: 'Actually, it may be difficult to tell whether the margin surge is a cause or effect of the broader stock market rally. However, it's clearly something that investors are watching closely."



WEDNESDAY, JULY 30TH

- The Commerce Department reports America's gross domestic product (GDP) grew at a 4% annualized rate in the 2nd. quarter, following a 2.1% contraction in the 1st. quarter, citing gains in consumer spending and business investment.



- In a statement issued following its regularly scheduled monetary policy meeting in Washington, the Federal Open Market Committee (FOMC) noted: "A range of labor market indicators suggests that there remains significant underutilization of labor resources in the domestic economy." Simultaneously, the FOMC continued to taper its monthly bond purchases to $25 billion (U.S.) with its sixth consecutive $10 billion (U.S.) reduction, maintaining a pace to end the purchase program in October. To date, the Fed's quantitative easing (QE) policy has added $4.41 trillion (U.S.) in mortgage-backed securities and U.S. Treasurys to its balance sheet holdings.

Federal Reserve Board Chairwoman Janet Yellen.
Photo source: Bloomberg

- The Roseland, New Jersey-based ADP Research Institute reports American companies added 218,000 workers to their private payrolls in July, following 281,000 hires in June. Laura Rosner, an economist at BNP Paribas in New York, noted: "Since consumer demand is returning, it should propel more hiring."

- Front Page Headline, Washington Post – "One Third of American Consumers with Credit Files Had Debts in Collections in 2013. According to a new study released this week by the Washington-based Urban Institute and Encore Capital's Consumer Credit Research Institute, approximately, 77 million Americans have a debt in collections. That amounts to 35% of consumers with credit files, or data reported to a major credit bureau. Caroline Ratcliffe, a senior fellow at the Urban Institute and author of the report, warns: 'It's a stunning number and it threads through nearly all communities.' The report analyzed 2013 credit data from TransUnion to calculate how many Americans were falling behind on their bills. It looked at how many people had non-mortgage debts; such as credit card bills, child support payments and medical bills, which are so past due that the account has since been closed and forwarded to collections. Researchers relied upon a random sample of 7 million people with data reported to the credit bureaus in 2013, in order to estimate what share of the 220 million Americans with credit files have debts in collection.

  This is the first time that the Urban Institute has calculated the collection figure, but Americans could have been struggling with debt for some time. Researchers noted that the 35% figure is basically unchanged from when the Federal Reserve studied this issue in 2004 and discovered that 36.5% of people with credit reports had debt in collections. The debts forwarded to collections ranged from $25 (U.S.) at the low end to in excess of $125,000 (U.S.) at the high end. Many consumers were burdened with relatively small amounts – about 10% of the debts were smaller than $125 (U.S.) – but the median debt level of $1,350 (U.S.) was still fairly substantial. Residents in Nevada were hit the hardest, with 47% of consumers with a credit file revealing a debt in collections. This was a mark which researchers surmised may have stemmed from the housing crisis, when people who were struggling to keep pace with their mortgage payments, may have fallen behind on other financial obligations. In 12 states, including the District of Columbia, more than 40% of residents with a credit file have a bill in collections: namely, Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, New Mexico, North Carolina, South Carolina, Texas and West Virginia.

At the opposite end, Minnesota, North Dakota and South Dakota each have about 20% of residents with credit files who have reported debt in collections. The phrase debt collection normally brings to mind dealing with harassing phone calls, repeated letters and other efforts from third parties attempting to collect the payment. However, not all consumers get hassled, since some people may not even learn they've been sent to collections until they check their credit reports. That doesn't mean the debt didn't cause any setbacks. Bills which are forwarded to collections can remain on a person's credit report for as long as seven years, negatively impacting a consumer's credit score and in turn, hindering their chances of accessing loans, credit cards and other forms of credit. A low credit score can also make it more difficult to land a job, or reduce their odds of getting approved for an apartment.

The study found that the share of people with debt past due, meaning they are at least 30 days late with a payment on a non-mortgage debt, was much smaller at 5%. That includes people who are late with credit card payments, student loan payments and auto loan remittances. A 79% majority of those people also had debt in collections. However, since certain bills such as medical bills and parking tickets, may not be included on a person's credit score until they are forwarded to collections, the total share of people falling behind on their bills may actually be much higher. The Urban Institute report did not break down which types of bills were the most likely to be forwarded to collections, so researchers could not distinguish between debts that were sent to collection years ago and those which were added more recently.

THURSDAY, JULY 31ST

- The Labor Department reports U.S. initial claims for state unemployment benefits increased by 23,000 to 302,000 in the week ended July 26th. from a revised level of 279,000 the previous week; while continuing claims rose by 31,000 to 2.54 million in the week ended July 19th. The unemployment rate for people eligible for benefits held steady at 1.9%.

- Statistics Canada reports the nation's gross domestic product (GDP) grew by 0.4% in May and by 2.3% on a year-over-year basis. Jonathan Bendiner, an economist at the Toronto-Dominion Bank, observed: "The May GDP performance augers well for Canada's export sector, which will be increasingly relied upon to fuel economic growth, since domestic sources of GDP growth are likely to wane."

- Front Page Headline, Financial Times – "Argentina's Endless Debt Dilemma. Argentina's 12-year dispute with a group of hedge funds holding out for full payment on defaulted Argentine bonds is proving to be one of the most wasteful debt restructurings in history. During the past few years, an unedifying legal battle waged in New York courtrooms has steadily unpicked the restructurings that allowed Argentina to pick up the pieces after its $95 billion (U.S.) default in 2001. Basing their rulings on a tight definition of the so-termed pari passu clause which guarantees equal treatment for bondholders, U.S. judges have declared it illegal for Argentina to make payments to the holders of restructured bonds, unless it includes full payments to holdout creditors as well. This week, the unresolved dispute reached its doleful climax.

Unwilling to bow to the demands of the holdout bondholders and consequently unable to keep the restructured bonds current either, Buenos Aires … withdrew its attempts to pay its creditors under U.S. law. Neither side can claim the moral high ground. Central to the holdout bondholders' case has been the precedent of two previous restructurings, wherein Argentina strong-armed creditors into accepting a savage haircut, worth only 25 cents on the dollar. However, if warrants linked to economic growth are included, the payouts in some cases have been worth much more. Of greater systemic concern, the points of law in the hedge funds' favour have led to a situation where it will be easier for other holdout creditors to block future sovereign restructurings. However difficult Argentina's behavior has been, this represents an unwelcome possibility. Wakeup call for the

Financial Times editorial staff: By your own admission below, Argentina has consistently behaved like its own worst enemy.

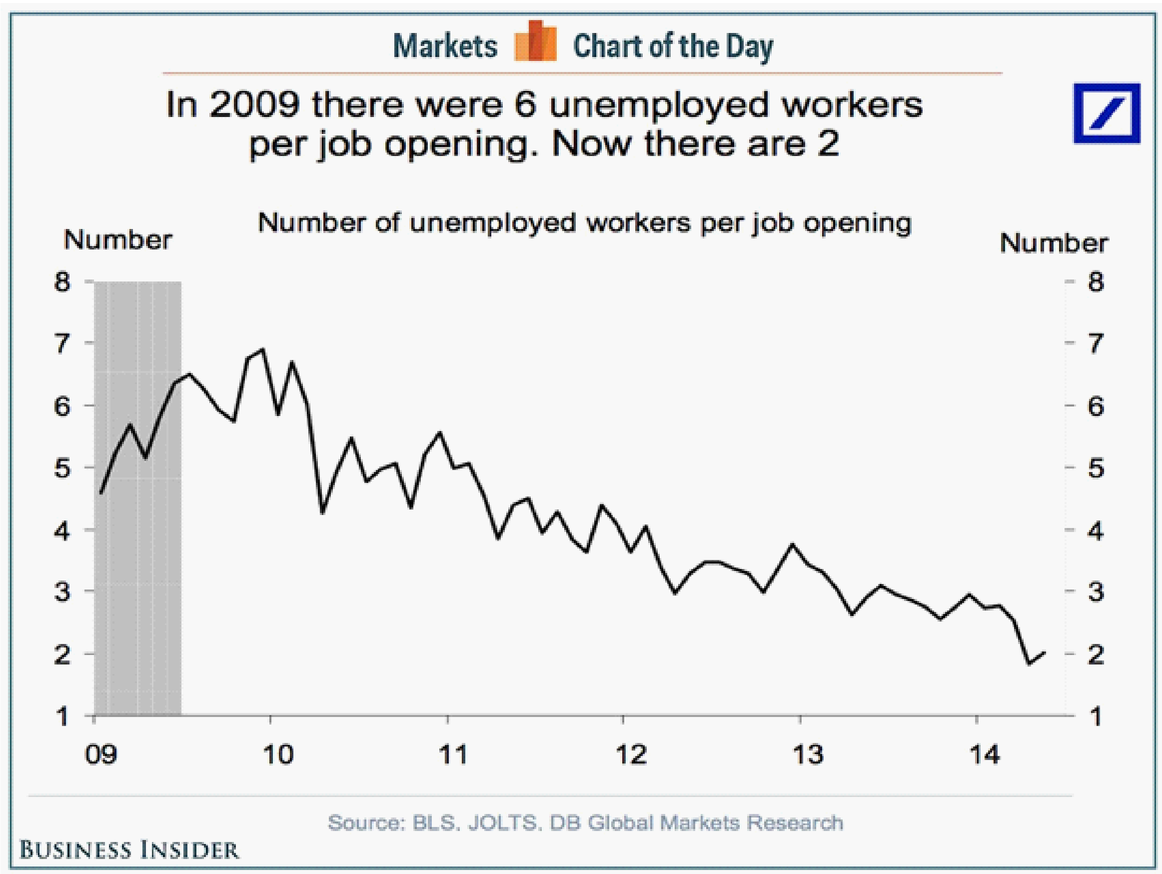
Argentine President Cristina Fernandez de Kirchner has reveled in her 'won't pay / can't pay' attitude. While this is central to her political image as someone who challenges financiers and wins, it is also a fiction. Argentina's restructurings have not reopened international fixed income markets. The bigger worry is that her intransigence poses a real threat to the economic well-being of her compatriots. Although the initial reaction has been muted, Argentina's default is likely to lead to a squeeze in trade finance and higher financing costs. Argentina has no easy options. Restructuring all of its debt into bonds issued under local law would be one way of thumbing its nose at the pesky creditor holdouts and the U.S. courts. However, the costs would be huge. A general default could lock the country out of the capital market for years, at a time when it needs international capital to develop its deposits of shale gas."

FRIDAY, AUGUST 1ST

- The Tempe, Arizona-based Institute for Supply Management reports its U.S. factory output index rose to a reading of 57.1 in July, following a level of 55.3 in June, citing higher purchases of automobiles and business equipment. In an interview, ISM Survey Chairman Bradley Holcomb told reporters: "This is clearly a nice uptick. It's representative of the new orders stream which keeps building and in anticipation of more of the same during the second half."

- The Thompson Reuters / University of Michigan group reports its index of consumer sentiment declined slightly to a reading of 81.8 in July from a level of 82.5 in June. Dean Maki, an analyst at Barclays, commented: "Overall, today's report shows consumer sentiment in the same narrow range where it has remained so far this year, but well below readings seen during the housing bubble. So, it remains consistent with continued moderate growth in consumer spending."

- The Labor Department reports U.S. non-farm payrolls increased by 209,000 in July, following an upwardly revised increase of 298,000 in June; while the official unemployment rate rose slightly to 6.2% from 6.1%.



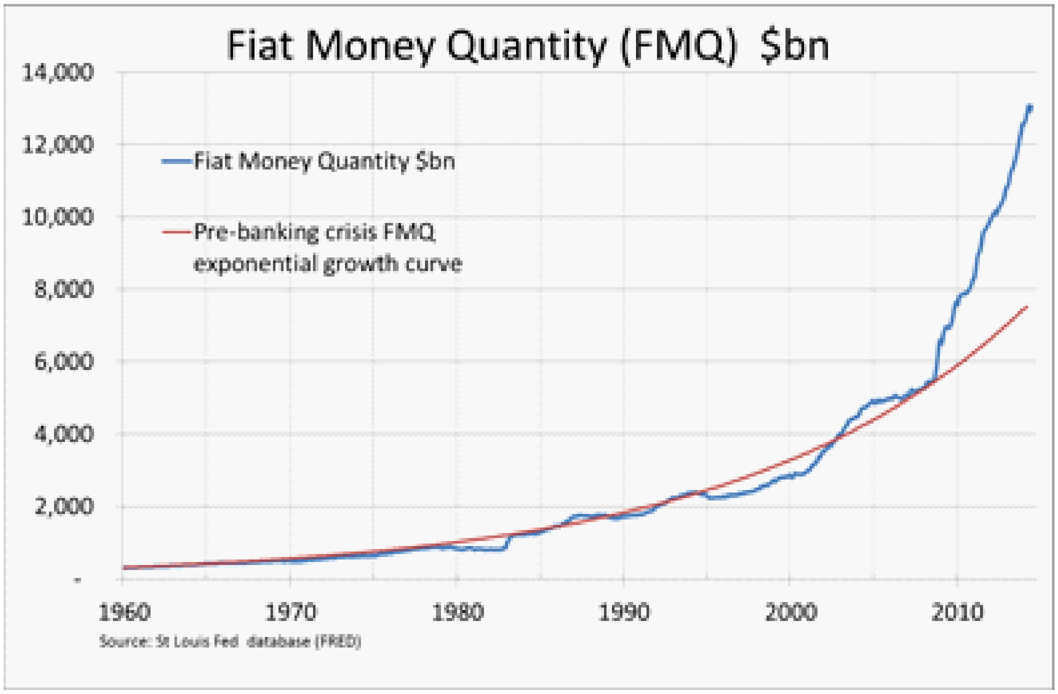
- RBC reports its Canadian Manufacturing Purchasing Managers' Index (PMI) – a measure of manufacturing business conditions – rose to a seasonally adjusted reading of 54.3 in July, an 8-month high, from a level of 53.5 in June, citing higher gauges for new orders and employment.

- Front Page Headline, Gold Money – "USD FMQ Continues to Grow Despite Fed Tapering. Researcher Alasdair Macleod writes: 'The St. Louis Federal Reserve has just released the U.S. Fiat Money Components for June which stands at a record $13.132 trillion (U.S.).

  As can be seen in the chart below, it is $5.48 trillion (U.S.) more than an extension of the pre-Lehman crisis exponential growth trend. It should be borne in mind that there may be seasonal factors at play, since dips in the growth rate have been discernable at this time of year in the past. So, the slower growth rate of FMQ, up by $44 billion (U.S.) in the 2nd. quarter when it might have increased as much as $150 – $200 billion (U.S.), is not necessarily due to Fed tapering of Quantitative Easing 3. If tapering were responsible for slowing growth in FMQ, we could expect to see some strengthening in short-term Treasury Bill rates. However, as the chart below shows, short-term T-Bill rates have been in a declining trend since November 2013. The chart confirms that Fed tapering seems to be having little or no effect on money markets, i.e. axiomatically, on the growth rate of fiat currency. Weakness in short-term interest rates is also consistent with poor demand in the domestic economy.

On Wednesday of this week, the initial estimate of U.S. gross domestic product (GDP) was released of growth at a 4% annualized rate. This upturn conflicts sharply with the lack of any meaningful demand for credit, until one examines the underlying estimates. Of this 4% expansion, the change in real private inventories added 1.66%. In other words, GDP based upon goods sold, was only 2.34%. That changes in unsold goods – which is what inventories represent – should be part of final consumption, is a dubious proposition … According to the technical note accompanying the release, figures for inventories and durable goods – which showed an incredible rise of 14% – are estimated and not hard data, so they are subject to future revision. On this basis, the upside surprise GDP figure is little more than a government econometrician's guess until the real data becomes available. Suspicions that these guesses err on the optimistic side are confirmed by the experience of the 1st. quarter GDP figure, which was ultimately revised sharply downwards when the hard data eventually surfaced.

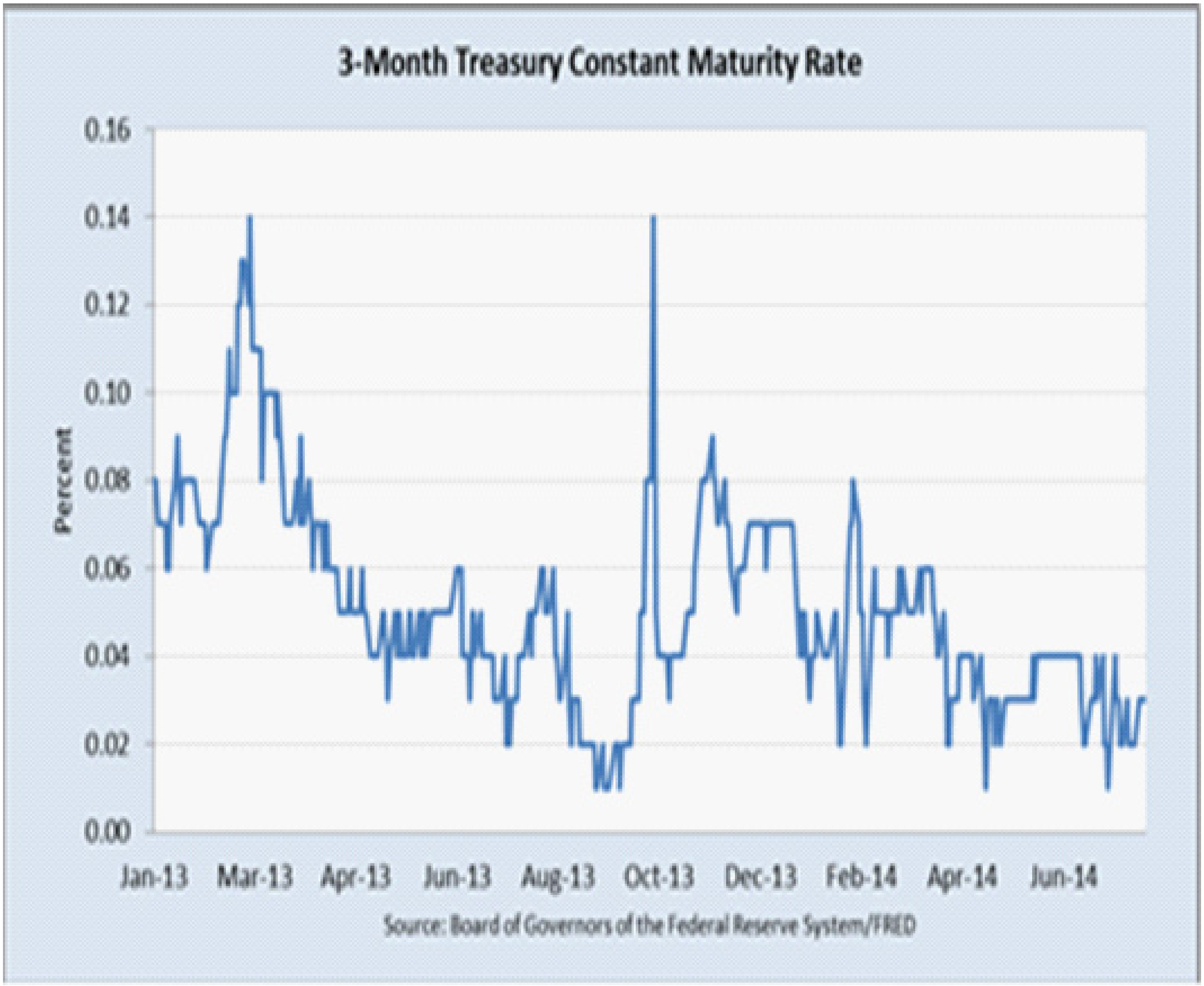
Whichever way one looks at FMQ, it continues to expand at a frightening pace, irrespective of the GDP upturn and its flaws. Furthermore, a look at the most recent Fed balance sheet confirms this view, showing that the August 1st. figure will be considerably higher, unless there is an offsetting contraction of bank credit. At present, there is little sign of any such contraction. From the current levels of short-t erm money market rates, we can conclude that the American economy is going nowhere fast; not only contrary to this week's GDP estimate, but also, that



that domestic credit demand essentially emanates from financial activities. However, should GDP estimates result in being far too optimistic, what if the U.S. economy stalls or even slumps? Wouldn't that lead to a reversal of FMQ's growth trend? Essentially, this is the argument of the deflationists. In an economic slump, they expect a dash from credit into cash as asset prices tumble. The counterpart of credit is deposits, which are the major components of FMQ and without Fed intervention, FMQ would rapidly contract. However, in the event of an economic slump, the Fed cannot be expected to stand idly by without taking extraordinary measures: in the words of Mario Draghi at the European Central Bank (ECB), 'whatever it takes." .

- Front Page Headline, Daily Telegraph U.K. – "U.S. Judge Warns Argentina to 'Stop Spouting Half Truths' over Default.

Argentina's President Cristina Fernandez de Kirchner.
Source: AFP



U.S. District Judge Thomas Griesa, who is overseeing Argentina's debt negotiations after the country agreed to hold talks under New York law, has ordered the Fernandez de Kirchner government to return to the negotiating table because 'nothing will eliminate Argentina's obligations to repay bondholders.' The Argentine government has repeatedly denied that it has defaulted, blaming the U.S. government for preventing it from agreeing with a deal with bondholders. Noting that Argentina is already grappling with an economy in recession, as well as one of the highest inflation rates in the world.

CLOSING LEVELS FOR FRIDAY AUGUST 1ST.		WEEKLY CHANGE
Dow Jones Industrial Average	16,493.37	– 467.20 points
Spot Gold Bullion	$1,294.80 (U.S.)	– $8.50 per oz.
S&P / TSX Composite	15,215.26	– 239.78 points
10 – Year U.S. Treasury Yield	2.49%	+ 2 basis points
Canadian Dollar	91.52 cents (U.S.)	– 0.95 cent
U.S. Dollar Index Future	81.297	+ 0.261 cent
WTI Crude Oil Futures	$97.88 (U.S.)	– $4.21 per barrel

Ian A. Gordon, The Long Wave Analyst www.longwavegroup.com