UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

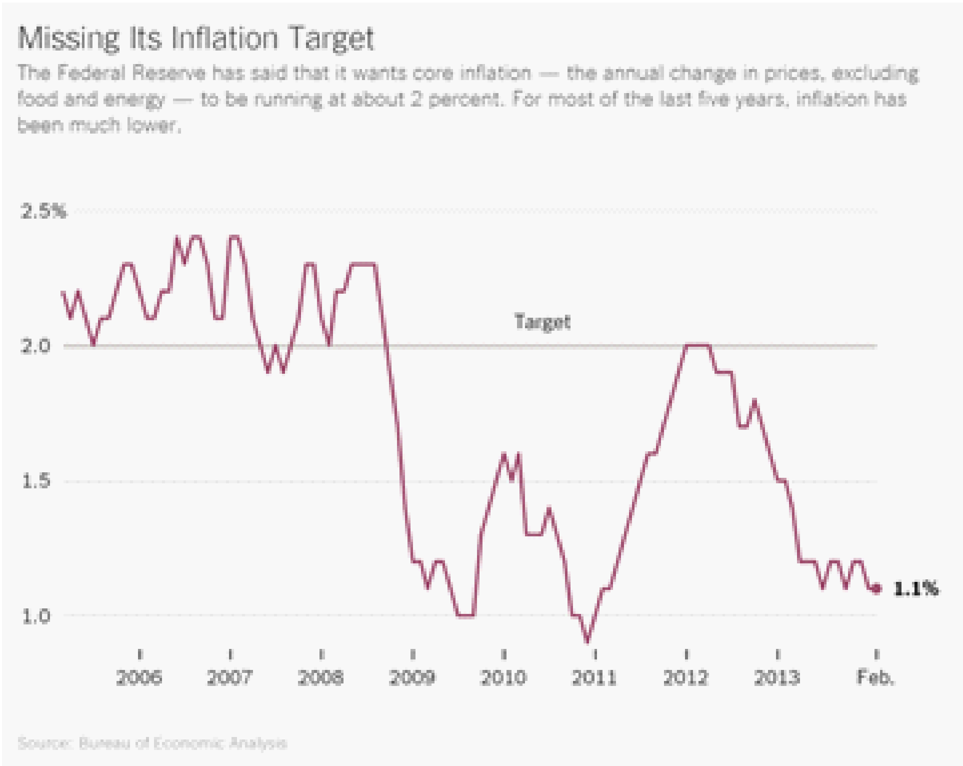
THAT WAS THE WEEK THAT WAS

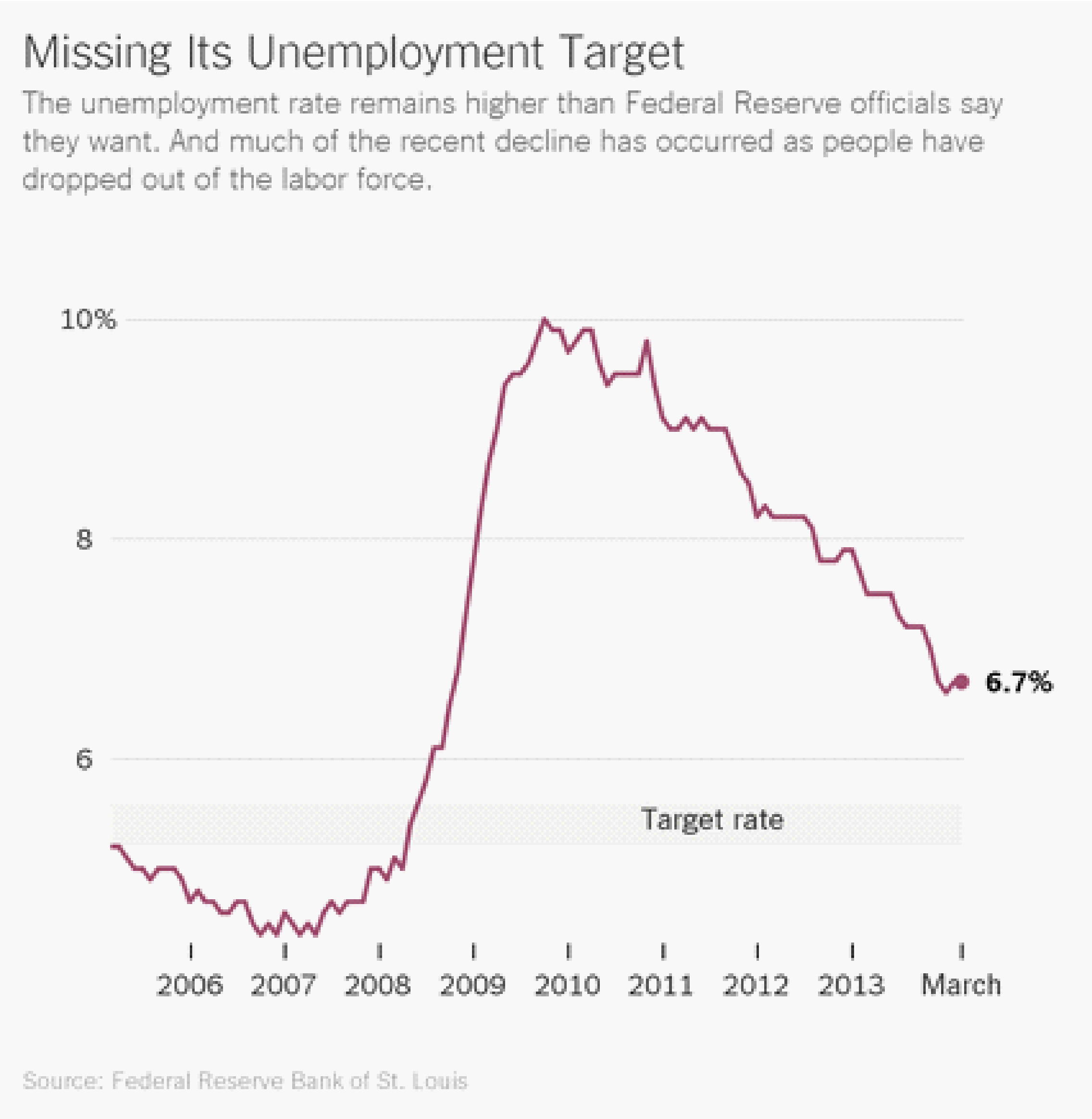
Monday, May 5th

Front Page Headline, New York Times – "By Its Own Yardstick, U.S. Fed Is Falling Short. In a NY Times op-ed, reporter B.C. Appelbaum writes: 'The U.S. Federal Reserve is failing to discharge its dual mandate. The Fed is charged with two fundamental

MONDAY, MAY 5TH

responsibilities by the U.S. Congress: i.e. to maintain the inflation rate at a moderate pace and to maximize employment.' Over the past five years, despite the implementation of an historically aggressive monetary policy; with the Federal Funds rate in the 0% - 0.25% range and a sizeable quantitative easing program consisting of U.S. Treasury and mortgage-backed securities purchases, 'the Fed has made little progress on either front. The share of American adults with full-time jobs fell sharply during the recession and has since only partly recovered. While the official unemployment rate has declined, it is primarily because the unemployed have stopped looking for work. Meanwhile, the inflation rate remains well below the Fed's core target of 2%.'





The official unemployment rate was restated by the U.S. Bureau of Labor Statistics at 6.3% on Friday. The Fed obviously takes an optimistic view. Its senior officials have acknowledged that they failed to do enough in 2011 and 2012. Since monetary policy works slowly, the consequences of those moderate policy decisions are playing out now. However, Fed officials predict that their current efforts will be sufficient to return unemployment and the inflation rate to healthy levels by the end of 2016. Time will tell.'

At Long Wave Analytics, we have oft stated that the reason the U.S. gross domestic product (GDP) has not recovered to the Fed's expectations, is because excessive debt levels have yet to be expunged from the economy. Indeed, the Fed and the U.S. Congress have only exacerbated the U.S. debt problem with the Fed's balance sheet now exceeding $4 trillion (U.S.) – or $4,000,000,000,000 and the U.S. national debt level surpassing $17.5 trillion (U.S.) – or $17,500,000,000,000. See also, Economic Winter – It's Still the Debt, Stupid – March 21, 2014.

- HSBC Holdings and Markit Economics report their purchasing managers' index (PMI) for China's manufacturing sector rose slightly to a final reading of 48.1 in April from a level of 48.0 in March; citing a contraction in output and in new orders, both domestic and for export. The index has registered a sub-50 reading for four consecutive months.

TUESDAY, MAY 6TH

- The Commerce Department reports the U.S. trade deficit narrowed by 3.6% to $40.4 billion (U.S.) in March, following a deficit of $41.9 billion (U.S.) in February. Exports increased to $193.9 billion (U.S.) from $190 billion (U.S.) in February, based on higher demand for aircraft, automobiles and fuels. While exports to Germany were the highest since October 2008, increased exports were also paced by stronger demand from South Korea, Canada and the countries in the CAFTA-DR trade zone, which includes Central America and the Dominican Republic.

- Front Page Headline, Globe and Mail – "Canada Needs More Specific Jobs Data: Auditor-General. In his Spring 2014 report, Canada's Auditor-General Michael Ferguson includes a broadly positive outline on the performance of Statistics Canada, but indicates that more could be done to track job vacancies. Statistics Canada only resumed tracking job vacancies in 2011, by adding two more questions to its business Survey of Employment, Payrolls and Hours. In his report, the Auditor-General notes: 'While Statistics Canada reports job vacancies by province, it does not specify where in the province there are labour shortages. In addition, Statscan's nomenclatures for job classifications are too broad. For instance, Statistics Canada reports vacancies in a category entitled: "Professional, Scientific and Technical Services," which is a grouping that could include jobs in advertising, legal services, architecture and biotechnology research. As a result of such shortcomings, users have informed us that available information on job vacancies is of limited value to them."

Source: Globe and Mail

- Statistics Canada reports the nation's trade surplus declined to $79 million (CAD) in March, following an upwardly revised surplus of $847 million (CAD) in February, citing exports to the United States – the country's largest trading partner – fell by 2.5% while imports from America were 1% higher.

- Front Page Headline, National Post – "Germany Advises Its Citizens to Leave Eastern Ukraine. Issuing a statement from Berlin, German Foreign Minister Frank-Walter Steinmeier warned: 'Ukraine may only be a few steps away from military confrontation. Accordingly, we are advising all German citizens to leave eastern Ukraine regions.' All services at the international airport serving the Donetsk region – the most populous area of Ukraine – were suspended for eight hours today without explanation. One possibility is Ukraine's armed forces want to clear the airspace to advance their military operation against pro-Russian insurgents."

Armed pro-Russian militants take position in City of Donetsk. Source: Getty Images

WEDNESDAY, MAY 7TH

- The Congressional Budget Office (CBO) estimates the U.S. Federal Government posted a budget surplus of $114 billion (U.S.) in April, $1billion (U.S.) higher than in April 2013. Seven months into the current fiscal year ending September 30th., the CBO estimates the U.S. federal budget deficit is $301 billion (U.S.); approximately $187 billion (U.S.) lower when compared to the same period in 2013.

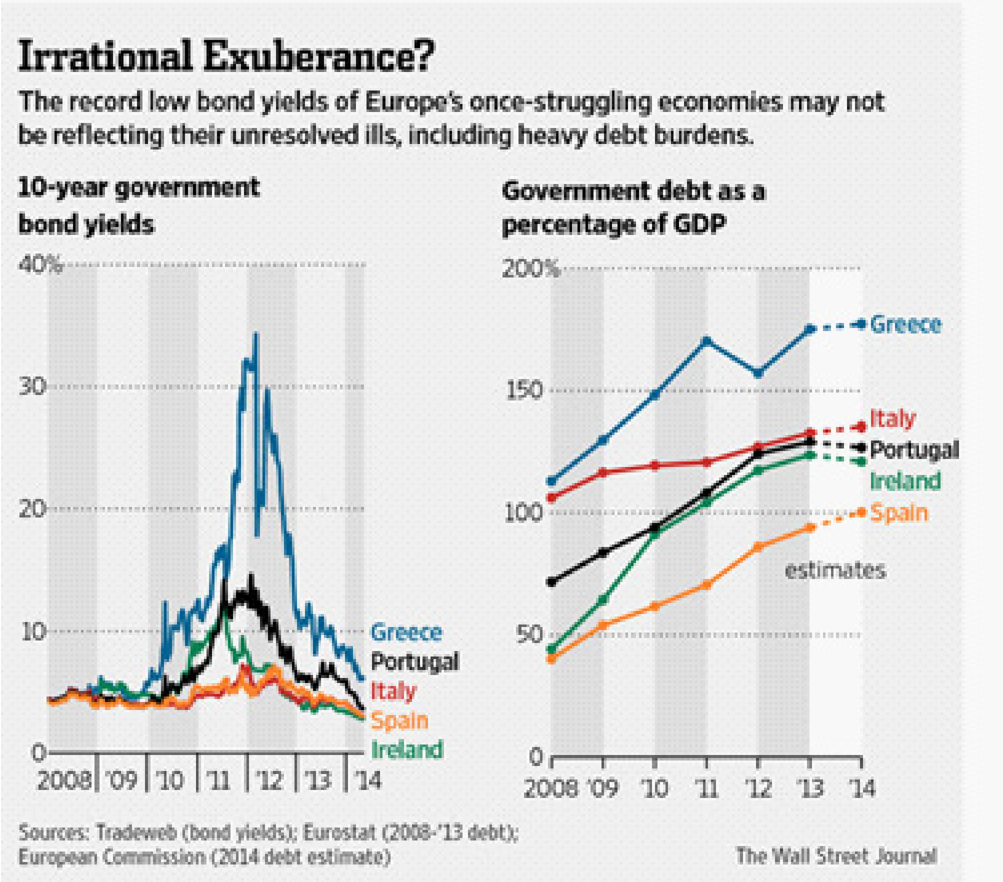
- In testimony before the Congressional Joint Economic Committee, U.S. Federal Reserve Chair Janet Yellen emphasized: "A high degree of monetary accommodation (for the economy) remains warranted. Many Americans who want a job are still unemployed and inflation remains below the central bank's 2% target." Michelle Meyer, an economist at Bank of America in New York noted: "Fed Chair Yellen wants to reiterate that there are still challenges and we are not out of the woods yet … Ms. Yellen put the labor market recovery in historical context, which is there are still a lot of scars left (in the economy) from the incredibly deep recession."

U.S. Federal Reserve Board Chair Janet Yellen.
Source: Bloomberg News

- Front Page Headline, Daily Telegraph U.K. – "ECB Seems Delighted by the Splendid Prospect of Deflation. The world is now in a 1930's plus era and the ratio of combined public and private debt is even higher. Therefore, the risks to debtor economies are that much greater. The United States, Britain and Japan have all taken radical monetary policy action in an attempt to stop this (disinflationary) metastasis. The European Central Bank (ECB) has not done so, even though five or six euro zone countries are already in deflation and most of them currently possess the highest debt to gross domestic product (GDP) ratios in their history. The ECB inflation model is clearly obsolete. Month after month, euro zone inflation has declined by more than was expected. The ECB was caught off guard when it dropped to 0.5% in March and again when the anticipated April rebound (due to Easter distortions) was only 0.7%.

Investors are in their own parallel universe, gripped by euphoria. Italian 10-year bond yields have dropped below 3% for the first time ever. Spanish bond yields have declined to 2.97%. Even Portuguese bond yields have fallen below 4% and Lisbon deems it safe enough to risk a 'clean exit' from its European Union (EU) / International Monetary Fund (IMF) bailout with no safety net. What these lower bond yields are telling us is a matter of hot debate.

Spain is the test case of the rebound story and has become the new poster child of European Monetary Union (EMU) austerity, the vindicator of internal devaluations. Spain's GDP grew by 0.4% in the 1st. quarter – the strongest in six years – even though exports declined by 0.6%. This was partly achieved by estimating the GDP deflator at minus 0.4%. If that is the actual



level of deflation already lodged within the Spain's economy, that country is in big trouble. Spain's nominal GDP contracted in each quarter of 2013: by 257 billion euros in Q1and by 255 billion euros in each of Q2, Q3 and Q4; carrying a total debt load of about 340% of GDP. The European Commission's (EC) latest report – described by Oxford Professor Kevin O'Rourke as 'self-satirising' for its paean to (economic) recovery – forecast Spain's public debt will keep rising to 100.2% this year and 103.8% in 2015.

It is much the same in Italy, where nominal GDP also contracted last year. Italy's public debt will rise to 135.2% of GDP this year despite a large primary surplus, just as Britain saw its debt ratio rise in the 1920s despite its primary surplus. This is the denominator effect and it is a trap. Ashoka Mody, former director of the IMF program for Ireland, believes Spain and Italy both need an inflation rate of 2% for several years to come, in order to keep nominal GDP off the reefs and to have any chance of restoring debt sustainability. Austerity measures are not enough. ECB President Mario Draghi acknowledged this trap in his most recent speech: 'The aftermath of a debt crisis often leads to a prolonged period of balance sheet adjustment, low GDP growth and possible risks of a debt deflation spiral. Students of economic history know that in past episodes debt overhangs have been reduced through higher inflation, which also makes competitiveness adjustments easier. Thus, fears might easily have arisen that the ECB might be tempted to do the same.' Mr. Draghi then vowed to resist this temptation. This is surreal. The ECB has failed, not only to meet its 2% inflation target, but also to comply with its other Treaty obligation of supporting jobs and economic growth. Oxford Economics' Gabriel recently stated: 'Euroland is in a sort of limbo where the rising confidence never quite seems to deliver the hard numbers later.

The Euro zone is generating almost no internal economic growth. It relies upon the rest of the world – especially upon Britain with its incorrigible spending and dangerous deficits – to lift it out of the doldrums' … Yet this is happening at a time when the U.S. Federal Reserve is cutting back new liquidity; China is trying to moderate a $25 trillion (U.S.) credit bubble; Japan's reflation boom has fizzled and much of the emerging market nexus is going into recession. The euro zone is the weakest region in the OECD, yet it has conducted its affairs in such a way that the euro is the hardest currency, trading at the pain barrier of $1.39 (U.S.) and at 141 yen, up 45% since mid- 2012. In turn, this is pushing Europe closer to deflation in a self-fulfilling process. The great mystery is why the voters in the euro debtor states continue to tolerate an arrangement that ensures years of mass unemployment and probably dooms their nations to bankruptcy, if, as or when the global economic cycle turns." See also, Economic Winter – Economics and War – April 28, 2014.

THURSDAY, MAY 8TH

- Front Page Headline, Bloomberg News – "Barclays Announces 7,000 Investment Bank Layoffs by 2016. Via an analyst conference call, Barclay's Chief Executive Officer (CEO) Antony Jenkins remarked: 'The investment bank is too exposed to volatility in fixed income, currencies and commodities. The layoffs will primarily target the U.K. and the U.S. … while the Asian unit will remain more focused.' Mr. Jenkins' plan will bring the number of jobs to be cut across the firm by 2016 to 19,000; including the 12,000 layoffs announced in February that the bank intended to eliminate this year. As a result, Barclays will create a bad bank to dispose of 115 billion pounds ($195 billion U.S.) of assets, including its European consumer arm."

- Researcher Retail Metrics Inc. reports U.S. retailers posted a 6.2% same store (those open for at least a year) sales gain in April, the biggest increase since June 2011; citing better weather, a late Easter and aggressive promotions attracted shoppers. In a statement, Retail Metrics President Ken Perkins cautioned: "Retailers need to carry through with solid Mother's Day and Memorial Day weekend sales leading to a positive May result before we would feel more comfortable that the consumer is back."

- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 26,000 to a seasonally adjusted 319,000 in the week ended May 3rd. while continuing claims fell by 76,000 to 2.69 million in the week ended April 26th.

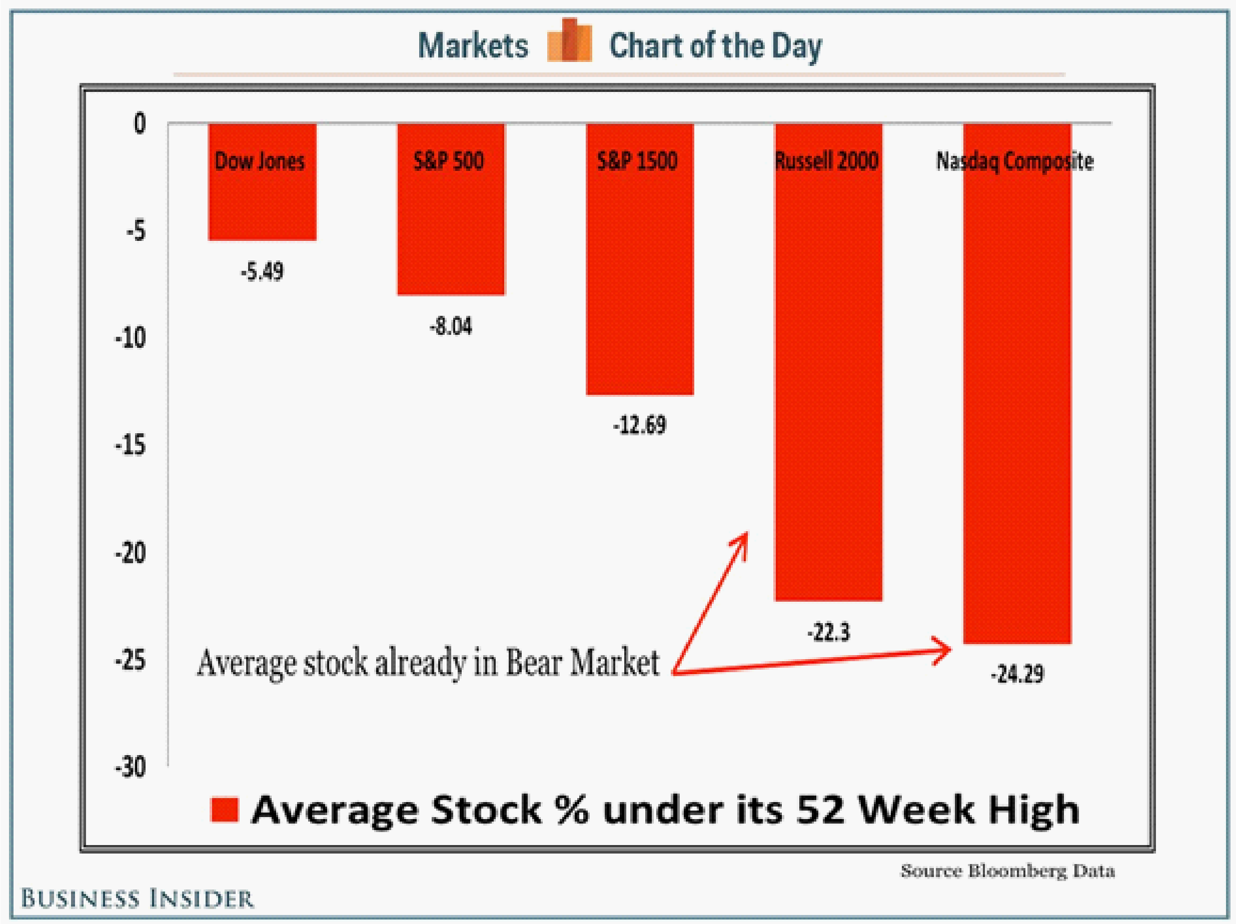
FRIDAY, MAY 9TH

- Statistics Canada reports the nation's official unemployment rate remained unchanged at 6.9% in April. However, the Canadian employment level actually declined by 28,900 people in April and 25,600 people left the labour force, reducing the participation rate to 66.1%, its lowest level since November 2001. The report pushed the Canadian dollar 62/100's of a cent lower against its American counterpart to close the week trading at 91.78 cents (U.S). Charles St-Arnaud, a London-based economist at Nomura Securities International observed: "Canadian exports remain sluggish – particularly to the United States – so they are not strong enough to support gross domestic product (GDP) growth."

Bank of Canada Governor Stephen Poloz has recently stated that 'output growth is being hobbled by low business investment and weak exports.' Source: Bloomberg News

- Front Page Headline, Business Insider – "The Average Stock Is in a Bear Market. There are no perfect stock market indexes which reveal a complete picture of the state of the stock market. While the Dow Jones Industrial Average (DJIA) still commands a lot of attention, most market-watchers prefer the S&P 500. At present, the S&P 500 is down by only 1% from its all-time high level of 1,897 but that belies the fact many share prices in the index are down considerably. J.C. O'Hara, an analyst at FBN Securities notes: 'When we examine breadth in terms of new market highs – more specifically, stock prices that are within striking distance of a new high – we see a completely different picture. Often at the end of bull markets, large cap stock prices continue to rise, while smaller stock cap prices begin to level off or decline. The S&P 500 is cap-weighted, which means larger companies such as Microsoft and Exxon Mobil have a much bigger impact on how the index moves, thus masking internal weakness.'

  Mr. O'Hara's research found that the average S&P 1500 stock price is down by more than 12% from its recent 52-week high. The average share price in the Russell 2000 and the Nasdaq Composite are down by more than 20%, which means one can say they are in bear markets. Mr. O'Hara cautioned: 'Historically, this sort of (average price) divergence does not bode well for the longevity of a (stock) market's upward inertia. We went back and examined instances where the stock market made a new high and looked at where the median stock price was compared to its high. Our data suggested that the current breadth reading is very unhealthy. Not only are new highs diminishing, but we are also seeing many stocks hitting new price lows. This



breadth divergence is a major concern. While this isn't necessarily a screaming sell signal, the powerful message that there is something wrong (in this market) should not go unnoticed."

- The United States Postal Service (USPS) reports it posted a net loss of $1.9 billion (U.S.) in the 2nd. quarter, as first-class mail volumes continued to decline. The USPS has recorded a loss in 20 of the last 22 quarters, while the U.S. Congress remains gridlocked on postal reforms.

CLOSING LEVELS FOR FRIDAY MAY 9TH.		WEEKLY CHANGE
Dow Jones Industrial Average	16,583.84	+ 70.95 points
Spot Gold Bullion	$1,287.60 (U.S.)	– $15.30 per oz.
S&P / TSX Composite	14,534.06	– 231.08 points
10-Year U.S. Treasury Yield	2.62%	+ 4 basis points
Canadian Dollar	91.78 cents (U.S.)	+ 0.71 cent
U.S. Dollar Index Future	79.869 cents	+ 0.361 cent
WTI Crude Oil Futures	$99.99 (U.S.)	+ $0.23 per barrel

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