

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

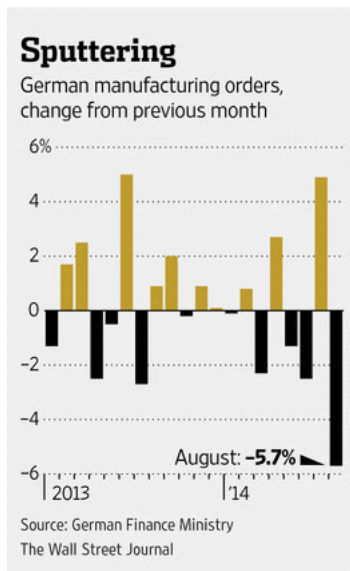


Monday, October 6th

The Economy Ministry in Berlin reports German factory orders, adjusted for seasonal swings and inflation, declined by 5.7% in August; the biggest drop since January 2009. While export orders fell by 8.4%, domestic demand was 2% lower and investment-goods

MONDAY, SEPTEMBER 1ST

orders plunged by 8.5%. Christian Schulz, a senior economist at the Berenberg Bank in London noted: “Geopolitical risks, especially the crisis in Eastern Ukraine, have made German companies cautious about their investment plans, despite favourable fundamental and funding conditions.”



causing a clash that would be the biggest test yet of new powers for Brussels that were designed to prevent a repeat of the euro zone’s sovereign debt crisis. Last month, France’s Finance Minister, Michel Sapin, disclosed his country would run a budget deficit of 4.3% of gross domestic product (GDP) for 2015; far from the 3% deficit it had previously pledged. Stripping out the effects of the weak economy, the French Government’s planned cost cuts would amount to just 0.2% of GDP, falling short of cuts totaling 0.8% that it had agreed upon with Brussels. The credibility of Brussels’ new powers threatens to be seriously undermined if big countries such as France are able to flout the new rules, which give the EC the right to demand changes to proposed budgets before they are presented to national parliaments. One of the EU officials noted: ‘People are underestimating what’s at stake is the entire credibility of the rules.’



France’s Finance Minister Michel Sapin.
Photo source: Reuters

- Front Page Headline, Wall Street Journal – “EC Prepares to Reject France’s Fiscal 2015 Budget. According to European Union (EU) officials (preferring to remain anonymous), the European Commission is preparing to reject France’s 2015 budget likely

TUESDAY, OCTOBER 7TH

- The U.S. Federal Reserve reports American consumer credit rose by a seasonally adjusted \$13.5 billion (U.S.) in August – the slowest pace since November 2013 – following a \$21.6 billion (U.S.) increase in July. Non-revolving loans, which includes borrowing for automobiles and college tuitions, climbed by \$13.7 billion (U.S.), the smallest increase since January.
- The Economy Ministry in Berlin reports German industrial production, adjusted for seasonal swings, declined by 4% in August – the biggest drop since January 2009 – following a 1.6% increase in July. Ralph Solveen, an economist at Commerzbank AG in Frankfurt, commented: “The German economy will expand at a rather slow pace during the 2nd. half of this year. In light of the weak trend in factory orders, we would not expect a great deal of GDP growth in the 4th. quarter.”
- Front Page Headline, Bloomberg News – “IMF Reduces Global Economic Outlook for 2015. In its latest World Economic Outlook report, the International Monetary Fund perceives: In advanced economies, the legacies of the pre-crisis boom and the subsequent financial crisis – including the high levels of public and private debt – still cast a shadow on the global economic recovery. Emerging markets are adjusting to rates of gross domestic product (GDP) growth lower than those achieved during the pre-crisis boom and the post-crisis recovery. A sustained period of monetary policy administered interest rates near the 0% range in advanced economies has raised the risk that some equity markets may be overheating. Downside risks related to an equity price correction in 2014 have also risen, consistent with the notion that some share price valuations could be frothy. However, we expect the U.S. GDP will grow by 2.2% this year and by 3.1% in 2015. Given the current slack in the U.S. economy, well-anchored inflationary expectations and downside risks to the economic outlook imply that the current accommodative monetary policy remains appropriate. We expect the euro zone’s GDP will grow by only 0.8% this year and by 1.3% next year. We see the euro zone’s major risk as a potential stalling of its economy, because the risk of recession is present. Meanwhile, we are predicting Japan’s GDP will expand by only 0.8% in 2015 and the Brazilian economy to grow by only 1.4% in 2015.”

WEDNESDAY, OCTOBER 8TH

- Canada Mortgage and Housing Corp. (CMHC) reports the nation’s housing starts totaled 17,343 in September, as builders focused on more multiple-unit buildings; marking a seasonally adjusted annual pace of 197,343 starts, up slightly from August’s annual rate of 196,283. CMHC noted the seasonally adjusted annual rate of urban starts in September declined in British Columbia and Atlantic Canada, while increasing in Quebec, Ontario and the Prairie Provinces.



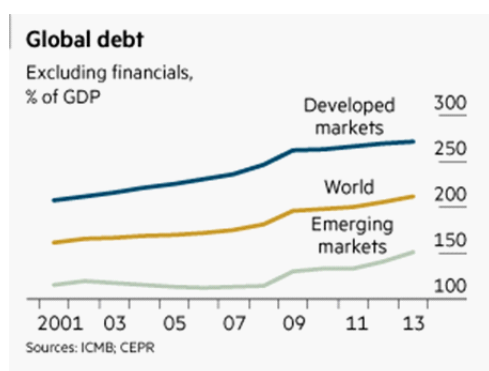
Cranes operate at a condominium construction site in Vancouver. Source: Bloomberg

- Front Page Headline, Financial Times – “The World Is Trapped in a Cycle of Credit Booms. In an op-ed, columnist Martin Wolf observes: Huge expansions of credit followed by financial crises and attempts to manage the aftermath have become a prime feature of the world economy. Today, the U.S. and the U.K. may be escaping from the crisis that hit seven years ago. However, the euro zone is mired in post-crisis stagnation and China is struggling with the debt it accumulated in its attempt to offset the loss of export earnings after the financial crisis hit in 2008. Without an unsustainable credit boom somewhere, the global economy seems incapable of generating gross domestic product growth in demand sufficient to absorb potential supply. It looks like a law of the conservation of credit booms.

Consider the past quarter century: a credit boom in Japan which collapsed after 1990; a credit boom in Asian emerging economies which collapsed in 1997; a credit boom in the north Atlantic economies that collapsed after 2007 and finally in China. Each credit boom is greeted as a new era of prosperity, only to collapse into crisis and post-crisis malaise. The authors of a fascinating new report, *Deleveraging: What Deleveraging?* do not entertain my dystopian hypothesis. Essentially, they consider these credit cycles to be independent events. Yet the report is invaluable. Clearly, it exposes the limited nature of post-crisis deleveraging, which is the plight of the euro zone and the group of big challenges now facing China. In considering the world economy taken as a whole, there has been no aggregate dele-

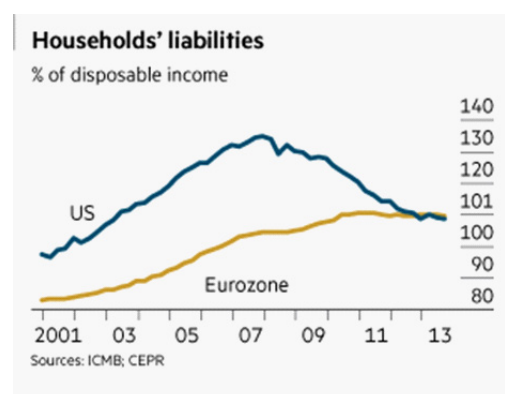
veraging since 2008. The same holds true for the high-income economies viewed as a single bloc. Financial sectors have deleveraged in the U.S. and the U.K., however, so too have households in the U.S. Moreover, to a lesser degree, the U.K. liabilities of households have even converged between the U.S. and the euro zone as a whole (see charts below).

Meanwhile, global public debt has risen sharply. That financial crises lead to increases in fiscal deficits was one of the most important findings of *This Time Is Different*, co-authored by Harvard's Kenneth Rogoff and Carmen Reinhart. Since the financial crisis, the ratio of public debt to gross domestic product (GDP) has jumped by 46 percentage points in the U.K. and by 40 percentage points in the U.S. against 26 percentage points in the euro zone. Even in the U.S., where private deleveraging has been rapid, overall deleveraging has been minor. This need not be a disaster, if the U.S. government's balance sheet is more robust than those of much of the private sector; it ought to be able to withstand the strain. Since 2007, the ratio of total debt – excluding the financial sector – has soared by 72 percentage points in China to 220% of GDP. While one can debate whether this level is sustainable, one cannot debate whether such a rapid rate of increase is sustainable. It cannot possibly be so. The rise in debt levels must halt with possibly significantly more adverse effects on China's rate of GDP growth than today's consensus expects.



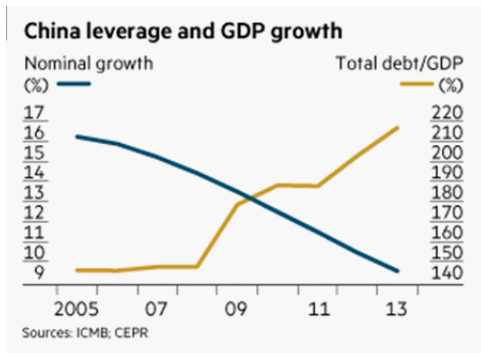
Credit cycles matter because they frequently prove so damaging. The report divided possible outcomes into three categories: in type 1, such as Sweden in the early 1990s, the level of output declines never to regain its pre-crisis trend, but the GDP growth rate recovers. In the more damaging type 2, as in Japan since the 1990s, there is no absolute decline in output, but potential GDP growth falls far short of the pre-crisis rate. Finally, in type 3, as in the euro zone now and probably the U.S. and the U.K., there is both a drop in output and a permanent decline in potential GDP growth. Several possible reasons exist for such permanent losses of output and GDP growth. One is the pre-crisis

trend was unsustainable. Another is the damage to confidence and so to investment and innovation from a financial crisis. However, among the most important, is the debt overhang. As the report shows, deleveraging is difficult. Mass bankruptcy, as in the 1930s, is devastating. However, working out of debt is likely to generate a vicious circle from high debt to low GDP growth and back to even higher debt levels. Today, long term interest rates are low in high-income economies. In the euro zone, this is largely due to the hollow promises to date from Mario Draghi, the European Central Bank President. Unfortunately, the growth of nominal GDP in the euro zone is also dismal: inflation is ultra-low and real GDP is growing weakly under the blows of fiscal retrenchment and structurally inadequate private demand.



Incredibly, the euro zone seems to be waiting for the Godot of global demand to float it off into economic growth and so to debt sustainability. That might work for the small countries, but it's not going to work for all of them. The report talks of 'a poisonous combination ... between high and higher debt loads and slow and slowing – both nominal and real – GDP growth.' In addition, the euro periphery is where this perverse loop of higher debt and lower GDP growth is severe. While that is no surprise, crisis-hit euro zone countries have been pedaling backwards, since the policies of the euro zone rule out needed GDP growth.

Managing the post-crisis predicament requires a combination of prompt recognition of losses, recapitalization of the banking sector and strongly supportive fiscal and monetary policies – where those are feasible – to sustain economic growth. The aim should be to use both blades of the scissors: On the one hand, direct debt reduction and recapitalization and on the other hand, strong GDP growth. The U.S. has come the closest to getting this combination right. However, the biggest lesson of these crises is not to allow debt to run ahead of the long-term capacity of an economy to support it in the first place. The hope is that macro-prudential policy will achieve this outcome. Well, one can always hope.

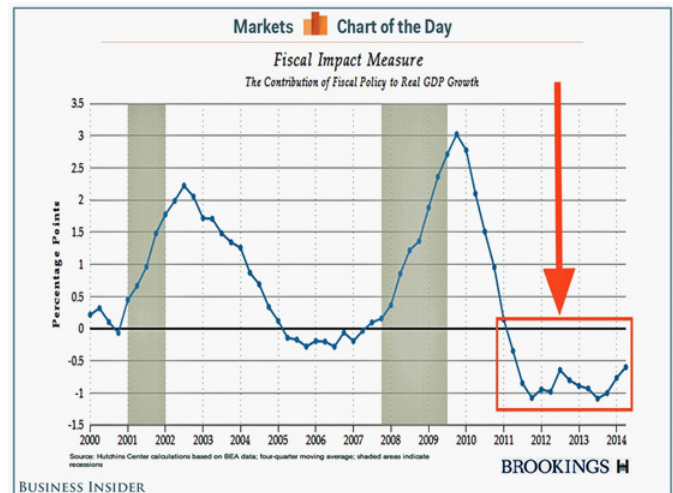


These credit booms did not emerge from nowhere. They are the outcome of the policies adopted to sustain demand as previous bubbles collapsed, usually elsewhere in the world economy. That is what has happened to China. The world needs to escape from this grim and apparently relentless cycle. However, for now we have made a Faustian bargain with private sector-driven credit booms. A great deal more trouble surely lies ahead.”

THURSDAY, OCTOBER 9TH

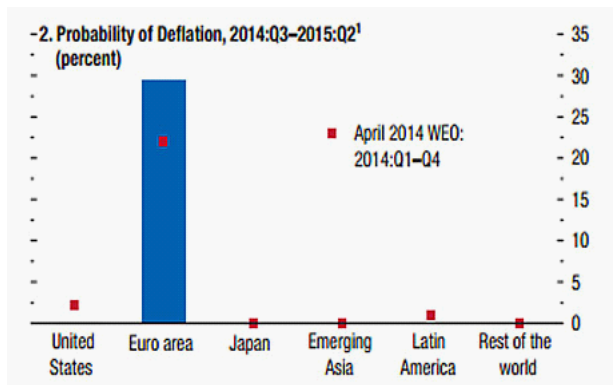
- The Labor Department reports U.S. initial claims for state unemployment benefits remained unchanged at 287,000 in the week ended October 4th. while continuing claims declined by 21,000 to a seasonally adjusted 2.38 million in the week ended September 27th. Guy Berger, an economist at RBS Securities in Stamford, Connecticut, observed: “We’ve witnessed a good record of employment growth year-to-date and there’s absolutely no indication that this trend is breaking heading into October.”
- Destatis – Germany’s Federal Statistics Office – reports the nation’s exports declined by 5.8% in August on a seasonally adjusted basis – the biggest drop since January 2009 – following an upwardly adjusted level of 4.8% in July. Timo del Carpio, an economist at RBC, commented: “While some special factors may be having an impact, we consider the statistical trend over the 3rd. quarter to date as presenting a clear downside risk to our 0.3% quarterly forecast for German GDP growth.”
- Front Page Headline, Wall Street Journal – “FOMC Minutes Reveal Wariness over Global GDP Growth. According to minutes of the September 16 / 17 monetary policy meeting of the Federal Open Market Committee – released yesterday – several officials expressed concern that disappointing gross domestic product growth in Europe, Japan and China and a strengthening U.S. dollar could restrain the expansion of U.S. exports, as well as the rate of inflation; making the FOMC more inclined to maintain a low administered interest rate policy.”

- Front Page Headline, Business Insider – “Congress Has Been a Drag on the U.S. Economy. In honor of the new fiscal year, the Washington-based Brookings Institution has released the Fiscal Impact Measure, an interactive chart by senior fellow Louise Sheiner which shows how the balance of U.S. government spending and tax revenues have negatively impacted domestic GDP growth. The bottom line is federal fiscal policies have been a drag on economic growth since 2011. The chart is similar to the ones produced internally by staff economists at the Federal Reserve for their policymakers. Janet Yellen delivered a major speech in February 2013 about how much of a drag U.S. fiscal policy has been on the economic recovery and she has mentioned it again since becoming Fed Chairwoman. (See chart below).



- Front Page Headline, Daily Telegraph U.K. – “German Economic Model Is Ruinous for Germany / Deadly for Europe. In an op-ed, International Business Editor Ambrose Evans Pritchard warns: The Kaiser Wilhelm Canal in Kiel is crumbling. Last year, authorities were forced to close the 60-mile shortcut from the Baltic to the North Sea for two weeks ... because the locks had failed. Large ships were forced to go around the Skagerrak, imposing emergency surcharges. The canal was closed again last month because sluice gates were not working, damaged by the constant thrust of propeller blades. The canal has experienced an ongoing saga of problems, the result of slashing investment to the bone and reducing maintenance funds from 60,000 euros to 11,000 euros. This is an odd way to treat the busiest waterway in the world, providing a thoroughfare to 35,000 ships a year, so vital to the Port of Hamburg. It is even odder, given that the German state can borrow 5-year funds at an interest rate of 0.15%. Yet, such is the economic policy of Germany, worshipping the false god of fiscal balance. The Bundestag is waking up to the economic folly of this policy. It has approved 260,000

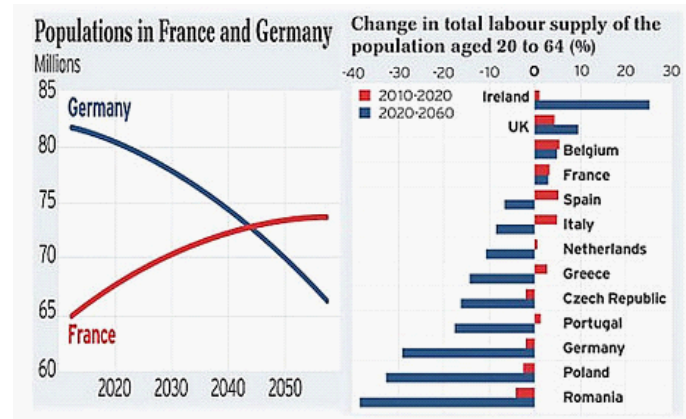
euros of funding to refurbish the canal over the next five years. Yet experts say it needs one billion euros; one of the countless projects crying out for money across the derelict infrastructure of a nation which has forgotten how to invest, sleepwalking into decline. France may look like the sick man of Europe, but Germany's woes run deeper, being rooted in mercantilist dogma i.e. the glorification of saving for its own sake and the corrosive psychology of aging. In a newly published book entitled: *The German Bubble: The Last Hurrah of a Great Economic Nation*, author Olaf Gersemann – Die Welt's chief economist – writes: 'Germany considers itself the model for the world, but pride comes before the fall. The second economic miracle from 2005 onwards has gone to Germany's head.'



Source: Daily Telegraph U.K.

Germany has mistaken a confluence of exceptional events for permanent ascendancy. Germany cannot continue to live off exports of capital goods to China and the BRICS as they hit the buffers, or by stealing a march on southern Europe via wage compression, a zero-sum game. Marcel Fratzscher, Director of the German Institute for Economic Research (DIW), makes a parallel critique (more Keynesian in flavour) in his new book, *Die Deutschland Illusion*, no translation needed. It is a broadside against the fiscal fetishism of Finance Minister Wolfgang Schäuble, now written into the constitution as a balanced budget law from 2016 onwards, making it almost impossible to override. It is the self-deception of a country 'resting on its laurels, prisoner of the household fallacy' that economies are like family budgets and falsely reassured by the misplaced flattery of foreigners who rarely look under the hood of a German automobile. The International Monetary Fund (IMF) gently prodded Berlin this week to pull its weight in a world economy gasping for demand, if only for its own good. The IMF stated: 'Germany could afford to finance much-needed public investment in infrastructure, without violating fiscal rules. There is a 40% chance of a triple-dip recession in the euro zone over the coming months and a 30% chance of deflation.' The German economy has already stalled. Output

contracted in the 2nd. quarter, while factory orders declined by 7.4% in August.



Professor Fratzscher accuses Germany's elites of losing the plot in every important respect. Investment has fallen from 23% to 17% of GDP since the early 1990s. Net public investment has been negative for twelve years. Annual GDP growth has averaged 1.1% since the beginning of the decade, placing Germany 13th. out of 18 in the euro zone (or 156th. out of 166 countries worldwide over the past 20 years). This chronic weakness has been masked by slightly better GDP growth since the Lehman crisis and by the creditor / debtor dynamics of the EMU debt crisis. Germany appears healthy only because half of Europe looks deathly. Germany's 'Five Wise Men' council of economic experts will reduce the country's GDP forecast for 2015 to 1.2% in a report on Friday. The Hartz IV reforms – so widely praised as the foundation of German competitiveness and now being foisted upon southern Europe – did not raise productivity, the proper measure of labour reform. Data from the OECD show that German productivity growth dropped to 0.3% a year in the period of 2007 to 2012, compared with 0.5% in Denmark, 0.7 in Austria, 0.9% in Japan, 1.3% in Australia, 1.5% in the U.S. and 3.2% in South Korea. Of course, Britain has been negative but that is no benchmark. Professor Fratzscher says the chief effect was to allow companies to compress wages via labour arbitrage. Real income has fallen back to the levels of the late 1990s. The legacy of Hartz IV is a lumpen proletariat of 7.4 million people on mini-jobs, part-time work that is tax free up to 450 euros a year.

This flatters the jobless rate, but Germany has become a split society, more unequal than at any time in its modern history. One fifth of German children are raised in poverty. Philippe Legrain, a former top economist at the European Commission, says Germany's 'beggar-thy-neighbour economic model' works by suppressing wages to subsidize exports, to the benefit of corporate elites. This is 'dysfunctional' and the more that EU officials attempt to extend the model across the euro zone, the

more dangerous it becomes. Capital flows within the EMU have been a form of vendor financing for buyers of German exports, but it should be obvious that such a structure must reach a breaking point – for Germany as well as the EMU – if France and Italy buckle to demands and follow Greece, Spain, Portugal and Ireland into wage deflation. Europe is already slowly sliding into a contractionary vortex ... doubling down would be calamitous.

Germany must move with great care. As Mr. Gersemann argues in his book, it is enjoying the last days of a particularly powerful demographic dividend, soon to reverse with a vengeance. The European Commission's Aging Report of 2012 forecast Germany's workforce would shrink by 200,000 per year in this decade. The old age dependency ratio will rise from 31% in 2010 to 36% in 2020, 41% in 2025, 48% in 2030 and 57% in 2045, tantamount to national suicide. This is a grave failure of public policy over decades. Tax policies and social structures have encouraged the collapse of the fertility rate. Lack of investment has compounded the error. Within five years it will surely become obvious to everybody that Germany is in deep trouble and a balanced budget will not prove any defence. Within ten years, France will be the dominant power of continental Europe."

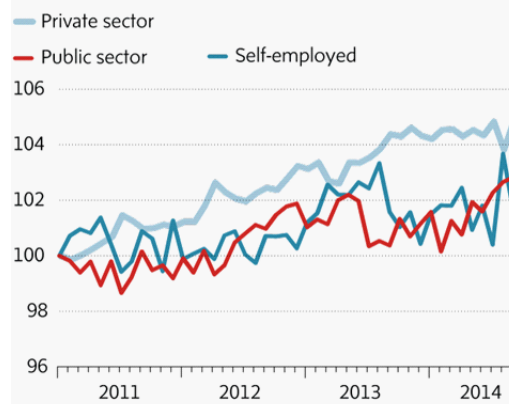
FRIDAY, SEPTEMBER 10TH

- Front Page Headline, MarketWatch News – "S&P Lowers France's Credit Rating Outlook. While maintaining France's sovereign credit rating at AA, Standard and Poor's Ratings Services lowered the country's credit rating outlook to negative from stable, citing: 'The French government's budgetary position is deteriorating in light of the country's constrained nominal and real gross domestic product (GDP) growth prospects.'"
- Front Page Headline, MarketWatch News – "S&P Downgrades Finland's Credit Rating. Standard and Poor's Rating Services downgrades Finland's sovereign credit rating to AA (High) from AAA citing: 'A deterioration in economic growth prospects which could complicate efforts to consolidate the country's public finances and reduce public debt. Finland's economic performance has lagged most of its peers, with gross domestic product (GDP) on a pace to contract in real terms this year, for the third consecutive year. Finland's underperformance on the export front indicates a sign of a reduced level of competitiveness. Finland is also vulnerable to neighbouring Russia's economic weakness and more significantly, to any slowdown of economic activity in the euro zone.'"

- Statistics Canada reports the nation's economy created 74,100 jobs in September, with most of the gains in full-time positions and within the private sector; while the official unemployment rate fell to 6.8% from 7%.

Employment index, private vs. public sector

January 2011=100



Source: Statistics Canada

- Front Page Headline, Daily Telegraph U.K. – "Can an Unstable Euro Zone Topple the Global Economy? In an op-ed columnist Jeremy Warner deliberates: At the U.S. Federal Reserve in Washington, there is concern bordering on alarm. By now, the world economy was meant to have been, if not exactly humming, at least bumping along merrily behind America's domestic economic recovery with a return to relatively decent levels of gross domestic product (GDP) growth. Instead, economic conditions have again been softening precipitously. GDP growth in Japan and China has disappointed investors, while the euro zone shows every sign of slipping back into recession; the third such contraction since the financial crisis of 2008-2009. In its World Economic Outlook, published last week, The International Monetary Fund (IMF) sharply reduced its forecasts for the main euro zone economies and assigned a near-40% chance to prospects of outright recession in the euro area as a whole. The chances of Japanese-style deflation are put as high as 30%.

All hopes that Europe's economic malaise was beginning to lift have been dashed. Even Germany, long the trusty mainstay of the European economy, is struggling with once buoyant export industries badly dented by weak demand elsewhere in Europe, slowing GDP growth in Asia and Russian trade sanctions. Suddenly, Europe is back center stage as the biggest threat to global economic recovery and GDP growth. Minutes of the last Federal Open Market Committee's (FOMC) meeting released last week in Washington, reveal evident alarm among U.S. policymakers that the worsening international economic outlook is inflicting

damage on the American domestic recovery. The point at which U.S. administered interest rates begin to rise – once widely expected towards mid-2015 – looks destined to be delayed again. Decidedly, that was the way the financial markets read the minutes. Thanks to Europe, the normalization of monetary policy will have to wait. Billions were wiped off stock values as investors absorbed the news that the economic recovery – so hard-won and long in coming – is again in danger of stalling. By the end of this week, many stock indices were down by a full 10% on the month, thereby satisfying the technical definition of a full-blown stock market correction. Next stop 20% – the classical definition of a bear market – some analysts were warning.

Adding his own voice to the chorus of alarm, U.K. Chancellor of the Exchequer George Osborne warned: 'This is a critical moment for the British economy. The euro zone risks slipping back into a financial crisis and Britain cannot be immune from that. Indeed, it's already having a negative impact on our manufacturing sector and our export trade.' At the IMF's recent annual meeting in Washington, few could resist finger-pointing at Europe and its apparent inability to resolve its problems. One senior European policymaker noted: 'It's like being under siege. Europeans are being made to feel that it's all their fault. We are the bad guys in the world economy, with Germany seen as Public Enemy Number One.' Of course, we have been here many times before. At the same meeting three years ago, it looked as if it was all over for the beleaguered euro, with the threat of disorderly collapse hanging like a pall over the entire world economy. However, Mario Draghi, President of the European Central Bank (ECB), then uttered his three magic words – 'whatever it takes' – and the immediate crisis began to subside. Unfortunately, it was a job only half done. The immediate sovereign debt and banking crisis had been stayed, yet the GDP growth did not return.

The patient had been rescued from near-death only to sink back into a state of chronic long-term illness. Three years later and Europe is still struggling to raise itself from its sick bed. Worse, its condition is again deteriorating sharply, leaving exasperated outside experts desperately casting about for solutions. At the IMF meeting, Managing Director Christine Lagarde urged the ECB to do more, including the purchase of sovereign bonds, so-termed quantitative easing. Better than anyone, Ms. Lagarde must know that Mr. Draghi's hands are tied. He is bound by treaty and German stricture not to do anything which resembles debt monetization and thereby, jeopardizes the German savings glut. Ms. Lagarde stated: 'Recession is avoidable, but only if the right policies are decided upon and if both surplus and deficit countries do what they must do. I am urging both a recalibration of fiscal consolidation programs and a rejuvenation of infrastruc-

ture spending.' By week's end, infrastructure had become the new call to arms, the latest mantra to ease Europe's pain and get the Continent back on its feet.

Meanwhile, Germany's Finance Minister, Wolfgang Schauble, opposes quantitative easing and is deeply suspicious of those who advocate more government spending as the solution to Europe's problems. Interacting at an IMF seminar with Larry Summers – the former U.S. Secretary of the Treasury – Mr. Schauble angrily dismissed the idea that the financial crisis was anything to do with failings in European policy. Mr. Schauble argued: 'America was the cause of this crisis, to be frank.' He refused to take lessons from Mr. Summers on how to manage Europe's affairs. Europe would proceed at its own pace with infrastructure spending, he insisted, with the European Investment Bank instructed to draw up a list of suitable projects which in time would be fully financed. Undeterred and comparing Europe's dismal economic performance to the Japanese stagnation of the past twenty years and the Great Depression of the 1930s, Mr. Summers persisted: 'What's being done in Europe is not working. They are just repeating the mistakes of Japan. What followed in Japan was fifteen years of deflation and dismal economic performance, followed by dramatic declines in administered interest rates. That is the path which Europe is on without a substantial discontinuity in policy.' In particular, Mr. Summers criticized Germany for what he characterized as a demand-side problem in the European economy. He insisted: 'You don't fix a lack of demand by adding more supply because that will only add to deflationary pressures.'

It is difficult to disagree with some aspects of Mr. Summers' analysis. Germany's current account surplus is about 8% of GDP. That means Germany's output is 8% higher than its spending. If Germany could be persuaded to increase its spending, this would make a huge contribution to rebalancing in the European economy as a whole. Even the normally ultra-dramatic Draghi seemed to join in with the German-bashing, indicating that he was willing to risk German fury by indulging in QE and naming Berlin as the one capital which could do more to support demand in fiscal measures. Decision makers from outside Europe urge some kind of grand bargain, whereby Germany agrees to reflate and allows the depression-engulfed periphery a little more fiscal space in return for a big-bang approach to structural and labour market reform. Yet, it may be that the crisis needs to deepen further before the merits of such an approach are accepted.

The thinking seems to be that only under pressure of economic ruin will recalcitrant nations embrace meaningful reform. For what it is worth, Mr. Summers said he could think of no case in

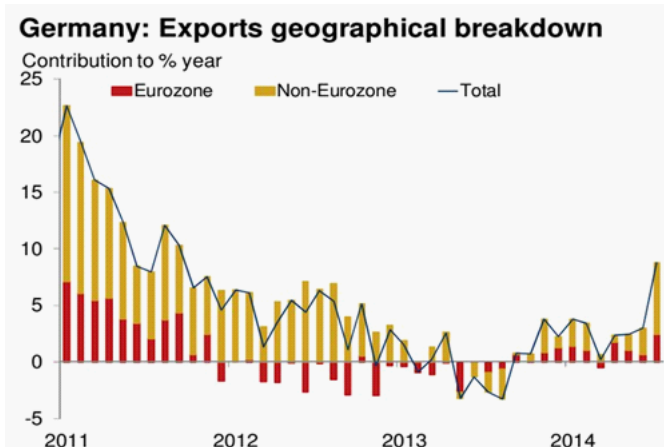
history where deflation acted as a powerful incentive to reform. On the contrary, strengthening demand and avoiding deflation would make reform politically very much easier. Bereft of any plausible path to debt mutualization and with many countries still struggling with record unemployment, time is again running out for Europe's experiment in monetary union. Perhaps the oddest thing about the whole sorry affair is that, despite the manifest fault lines, there are still no serious discussions about how to build the shared institutions and fiscal functions necessary for a sustainable currency union. Hesitant steps toward a banking union scarcely count when resolution and deposit insurance remain a firmly national responsibility. Early enthusiasm for shared social security arrangements and common labour market laws has petered out. In any case, Europe's problem is at the root not insufficient infrastructure spending, but rather bad governance and a dysfunctional monetary system.

Mr. Schauble excuses the lack of progress in establishing the shared fiscal arrangements necessary to underpin the single currency by insisting that political union was always going to be impossible in Europe. These were testing economic times, he conceded, but Europe had defied the skeptics. The currency union was still standing. Indeed it is, but for what purpose? If it be that of economic prosperity and harmony among nations, then it is having exactly the opposite effect. Far from uniting Europe, the euro is proving a powerfully divisive force. At the IMF, they deal only in the art of the possible and for now, the idea of lasting solutions to Europe's travails is regarded as too ambitious to be realistic. Europe may get there in the end, admits one official, but it is going to take many years and in the meantime, it's all about trying to make the best out of a bad job. Hence, the IMF's Damascene conversion to an infrastructure spending spree. Will it work? Even if Europe could be persuaded to loosen its debt targets to accommodate such an exercise, it's not certain that it would.

One only needs to look at Japan to see that infrastructure is not always the magic bullet fondly assumed. More than twenty years of building roads and bridges to nowhere has failed to lift Japan out of its economic funk. France's economic malaise is not for want of infrastructure spending; the country possesses some of the best infrastructure in the world. Similarly, Spain, Portugal, Ireland and even Italy, obviously do not need more roads, trains, houses and airports. To the extent that Europe has embraced an economic growth strategy during these past few years, it seems to rely upon the hope that the global economy as a whole will eventually lift all boats. With the best rate of GDP growth in the G7 this year, Britain has played the role of Europe's consumer of last resort. What Europe is getting wrong,

the U.K. seems largely to be getting right, from sticking to public spending plans, to welfare and other structural reforms. Like the U.S. it also has the support of accommodative monetary policy and the blessing of a highly flexible labour market. Much of Europe is still a million miles away from these basic building blocks. While the recognition is there, the political will is lacking. France may talk root and branch labour market reform, but words are not followed by meaningful deeds.

To make matters worse, the global economy is being hit by a series of external shocks, from renewed turmoil in the Middle East to Russian imperialism in Ukraine and now the possibility of a worldwide pandemic of the killer Ebola virus. As if all this wasn't enough, the emerging markets miracle – an important counter to the West's post-financial crisis stagnation these past five years – seems quickly be running into the sand, with China slowing fast as it attempts to rein in a runaway credit boom and Brazil close to recession. Meeting alongside the IMF, the G 20 made one of those characteristically vacuous commitments, i.e. to unleash hundreds of different measures which in themselves would raise global output by nearly 2%. Good luck with that one! It would be nice to depict the current alarm as just a passing squall, a temporary soft patch that will soon be behind us. Regrettably, this does not look like the way to bet; the oil price now at a four-year low tells a much grimmer story."



Source: Oxford Economics

- Front Page Headline, Sovereign Man – “Renminbi Deposits in Korea Surge by 55-Fold. The Bank of Korea – South Korea's central bank – has released data which indicates South Korean domestic deposits have reached 16.19 billion of Chinese renminbi last July, representing a 55-fold increase from the same period in 2013 when renminbi deposits accounted for only 290 million. Separately, according to data issued from South Korean banks, the proportion of foreign currency deposits held in ren-

minbi was 0.4% at the end of 2012. That number had reached 13.7% by the end of 2013, while at the end of July this year the renminbi accounted for 25.9% of all foreign currency deposits in South Korea. That represents an incredible, exponential increase. Since Korean administered interest rates continue to be relatively low and tend to closely follow those of most Western countries, Koreans realize that if they continue to hold their money in bank accounts denominated in renminbi, their savings are steadily and surreptitiously being diminished by an inflation rate that is higher than their paltry rates of return. With a lack of good investment opportunities in a near zero interest rate environment and with frothy equity markets, Koreans are at least diversifying their currency exposure with domestic capital rapidly flowing into renminbi deposits which have a higher annual yield at about 3.25%.

Coupled with the continued strength of the renminbi, the attractiveness of diversifying their capital in foreign currencies and the renminbi in particular is clearly becoming a firm trend among Koreans. This is a well-known scenario. Just as Europeans from countries with weaker currencies and economic prospects used to safeguard their savings by holding them in Deutschmarks and Swiss francs, we witness the same trend occurring today. Individuals, corporations and even governments are diversifying their currency exposure; mostly on account of the U.S. dollar. Renminbi denominated bonds are now being issued by businesses all over the world.”

- Front Page Headline, Business Insider – “The DJIA Is Now in the Red for 2014.



Friday's 115 point sell-off in the Dow Jones Industrial Average sent the 30-stock index into the red for the year. Closing at 16,544.10 points, the Dow is now below its December 31, 2013 close of 16,576 points. Some market analysts think that this is just a brief blip in the 5-year old bull market. Others warn this could be the beginning of something much scarier. See also, Ian's Investment Insights – Is This It? – October 10, 2014.

- Front Page Headline, GoldMoney – “A Gold Market Reset Is Due. Researcher Alasdair Macleod warns: Recent evidence points increasingly towards global economic contraction. Sections of the euro zone are in great difficulty and only last weekend Standard & Poor's Rating Agency warned that Greece will default on its debts 'at some point in the next 15 months.' Japan is collapsing under the wealth destruction of Abenomics. China is juggling with a debt bubble which is threatening to implode. Via government statistics, the U.S. tells us that the American outlook is promising, however, the reality is very different with one-third of employable adults unemployed. Furthermore, the GDP deflator is significantly greater than officially admitted. Moreover, the U.K. remains financially over-levered and overly dependent upon a declining euro zone.

This is hardly surprising because the monetary inflation of recent years has transferred wealth from the majority of the saving and working population to a financial minority. A stealth tax via monetary inflation has been imposed on the majority of people trying to earn an honest living on a fixed salary. While it has been unrecorded in consumer price statistics, it has occurred nonetheless. While six years of this wealth transfer may have enriched Wall Street, it has also impoverished Main Street. The developed world is now in deep financial trouble. This is a situation which may be coming to a debt-laden conclusion. Those in charge of our money know that monetary expansion has failed to stimulate an economic recovery. They also know that their management of financial markets – always with the objective of fostering confidence – has left them with market distortions which now threaten to derail bonds, equities and derivatives. Today, central banking's greatest worry is falling prices. The early signs are now upon us, reflected in U.S. dollar strength, as well as declining commodity and energy prices.

In an economic contraction, exposure to foreign currencies is the primary risk faced by international businesses and investors. The world's financial system is based upon the U.S. dollar as the reserve currency for all the others: it is the back-to-base option for international exposure. The trouble is that leverage among foreign currencies and the U.S. dollar have grown to highly dangerous levels, as indicated in the chart below.

| | US\$ - Billions | Gearing on 2013 Monetary Base | Gearing on pre- Lehman M0 |
|--------------------------------|-----------------|----------------------------------|------------------------------|
| Total world money 2013 | 168,501 | 39.7 | 191.6 |
| Global shadow banking 2012 | 71,000 | | |
| Foreign ccy broad money supply | 82,573 | | |
| US Bank deposits Dec 2013 | 9,932 | | |
| Monetary base Dec 2013 | 4,121 | | |
| Pre-Lehman Monetary Base | 875 | | |

Sources: St Louis Fed, Financial Stability Board, CIA Fact book

Plainly, there is great potential for currency instability, compounded by over-priced bond markets. Greece, facing another default, borrows 10-year money in euros at about 6.5%, while Spain and Italy borrow at 2.1% and 2.3%, respectively. Investors accepting these low returns should be asking themselves what will be the marginal cost of financing a large increase in government deficits, brought on by an economic slump. Obviously, an economic slump will escalate risk for owners of government bonds, or government guaranteed bonds.

The principal holders are banks whose asset-to-equity ratios can be as much as 40-50 times, excluding goodwill, particularly when derivative exposure is taken into account. The stark reality is that banks risk failure, not because of Irving Fisher's debt-deflation theory, rather because they are exposed to a government debt bubble which will inevitably burst: only a 2% increase in euro zone bond yields may be sufficient to trigger a global banking crisis. Fisher's nightmare of bad debts from failing businesses and falling loan collateral values will merely present additional burdens.

Prices

Macro-economists refer to an economic slump as deflation; however we face something far more complex worth taking the trouble to understand. The weakness of macro-economics is that it is not based upon a credible theory of prices. Instead of a mechanical relationship between changes in the quantity of money and prices, the purchasing power of a fiat currency is mainly dependent upon the confidence in which its users possess. This is expressed in confidences for money compared with goods and these preferences can change for any number of reasons. When an indebted individual is unable to access further credit, he may be forced to raise cash by selling marketable assets and by reducing consumption. In a normal econ-

omy, there are always some people doing this, however when they are outnumbered by others in a happier position, overall the economy progresses. An economic slump occurs when those who need, or want to reduce their financial commitments outnumber those who don't. There arises an overall shift in preferences in favour of cash, so all other things being equal, prices will fall. Shifts in these preferences are almost always the result of past and anticipated state interventions, which replaces the randomness of a free market with a behavioral bias. However, this is just one factor that sets price relationships: confidence in the purchasing power of government-issued currency must also be considered and will be uppermost in the minds of those not facing financial difficulties. This is reflected by markets reacting, among other things, to the changing outlook for the issuing government's finances.

If it appears to enough people that the issuing government's finances are likely to deteriorate significantly, there will be a run against the currency, usually in favour of the U.S. dollar upon which all currencies are based. So those holding dollars and becoming aware of the increasing risk to the dollar's own future purchasing power can only turn to gold and subsequently, to those goods which represent the necessities of life. When that happens, we have a crack-up boom and the final destruction of the U.S. dollar as money. So, the idea that the outlook is for inflation or deflation is incorrect and betrays a superficial analysis founded on the misconceptions of macro-economics. Nor, does one lead to the other: what really happens is the overall preference between money and goods shifts, influenced not only by current events, but also, by anticipated ones as well.

Gold

Recently, a rising U.S. dollar has led to a falling gold price. This raises the question whether further U.S. dollar strength against other currencies will continue to undermine the gold price. Let us assume that the central banks will ... attempt to prevent a financial crisis triggered by an economic slump. Their natural response is to expand the supply of money and credit. However, this policy-route will be closed to non-dollar currencies already weakened by a flight to the U.S. dollar ... Given this background to the gold price, Asians in their domestic markets are likely to continue to accumulate physical gold, perhaps accelerating their purchases to reflect a renewed bout of skepticism over their nation's currency. Wealthy investors in Europe will also buy gold, partly from bullion banks, but on the margin, demand for delivered physical gold seems likely to increase. Investment managers and hedge funds in North America will likely close their paper-gold short positions and go long when their

computers (which do most of the trading) detect a change in the trend. It seems likely that a change in the trend for the gold price in western capital markets will be a component part of a wider reset for all financial markets, because it will signal a change in perceptions of risks for bonds and currencies. With a growing realization that the great welfare economies are all sliding into an economic slump, the moment for this reset has moved an important step closer.”

| CLOSING LEVELS FOR FRIDAY, OCTOBER 10TH. | | WEEKLY CHANGE |
|--|--------------------|------------------------|
| Dow Jones Industrial Average | 16,544.10 | – 465.59 points |
| Spot Gold Bullion | \$1,221.70 (U.S.) | + \$28.80 per troy oz. |
| Spot Silver | \$17.38 (U.S.) | + \$0.54 per troy oz. |
| S&P / TSX Composite | 14,227.36 | – 562.42 points |
| 10 – Year U.S. Treasury Yield | 2.28% | – 15 basis points |
| Canadian Dollar | 89.15 cents (U.S.) | + 0.33 cent |
| U.S. Dollar Index Future | 85.472 | – 1.164 cents |
| WTI Crude Oil Futures | \$85.82 (U.S.) | – \$3.92 per barrel |
| DJIA / Gold Ratio | 13.54 | – 0.72 point |
| Gold / Silver Ratio | 70.29 | – 0.55 point |

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

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