Monday October 20th, 2014

LONGWAVE group

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

Monday, October 20th

Statistics Canada reports the nation's wholesale trade rose by 0.2% in August to a seasonally adjusted $53.07 billion (CAD), just shy of June's record level of $53.1 billion (CAD) and 6% higher on a year-over-year basis. July's previously reported decline of

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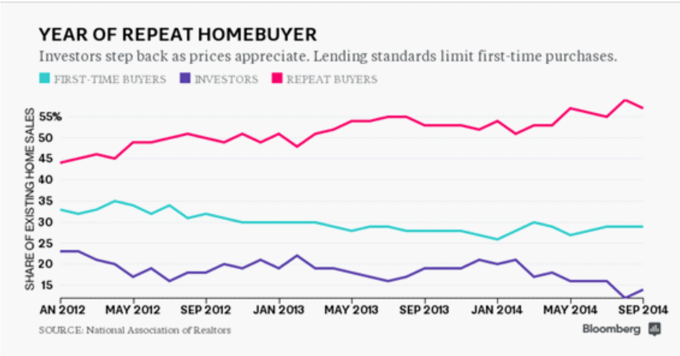
minus 0.3% was upwardly revised to minus 0.2%. The biggest gain was in the machinery, equipment and supplies category, which increased by a 3.6% to a record high.

- Front Page Headline, Financial Post – "Canada Retains Top Credit Rating for Twelfth Consecutive Year. In its annual Canadian credit analysis, Moody's Investors Service cited: 'Prudent financial policies and debt levels validate Canada's 'AAA' sovereign credit rating and stable outlook. Canada is projected to eliminate a budget deficit in the current fiscal year ending March 31, 2015 and post moderate surpluses in the subsequent years. Following a recession at the time of the global financial crisis, the Canadian economy recovered and continues to exert positive momentum, supporting improvement in government finances. The world's eleventh largest economy is challenged by household debt and rising house prices which pose a potential risk to the chartered banks and to the federal government directly, since it guarantees a considerable portion of the nation's mortgages. Another potential risk is the large debt load carried by the provinces; a contingent liability for the federal government. While the Province of Ontario – with $290 billion (CAD) of bonds outstanding – is carrying more debt than the State of California, it has a higher 'Aa2' credit rating resulting from the broad powers it possesses over its own revenues."

- Front Page Headline, Daily Telegraph U.K. – "ECB Begins QE Program. The European Central Bank has begun purchases of some French covered bonds – those backed by underlying loans – in an attempt to stimulate the floundering euro zone economy. It's not just the bonds of one country that the ECB will be acquiring; rather, as the central bank recently alluded: 'The program should be implemented in a uniform and decentralized manner.' The ECB also unveiled two other measures to lend support; an asset-backed securities purchase program and a series of fixed rate loans to banks."

TUESDAY, OCTOBER 21ST

- The National Association of Realtors (NAR) reports U.S. existing home sales rose by 2.4% in September to a seasonally adjusted 5.17 million annual pace, the highest level in 12 months. Brittany Baumann, an economist at Credit Agricole CIB in New York, commented: 'While we expect an upward trajectory in the housing market over the next few months, it's going to require further strengthening in the job market, low mortgage rates and a special importance based upon the easing of mortgage lending standards."



- Front Page Headline, Financial Times – “Euro Zone Economic Stagnation Is a Greater Threat than Debt. It would be wrong to think that last week’s global market gyrations signal a return of the euro zone debt crisis. Sovereign bond yield spreads did not move by much, except in Greece. What occurred last week is something rather different. Financial markets have awakened to the possibility of a euro zone-wide economic depression, with very low inflation over the next 10 to 20 years. This is what the decline in various measures of inflationary expectations tells us. Investors are not particularly worried about the insolvency of a member state as was the case two years ago. However the present situation is no less disturbing. The implications for those who live in such an economic snake pit are already visible: high unemployment; rising poverty; real and nominal wage stagnation; a high debt burden which refuses to drop in real terms, plus a decline in public services and public investment. A shocking example is the decrepit state of German military hardware. Of the Luftwaffe’s 254 fighter planes, 150 are unable to fly.

The euro zone’s stagnation will affect the rest of the world to different degrees. The U.K. could manage to escape the same fate; however, the euro zone economy is big enough to pull Britain down with it. Hardest hit will be the regions of central and Eastern Europe which do not use the euro. They are caught between an imploding Russia and a stagnating Europe. It is difficult to see how the oil price can recover in an environment of permanently low economic growth. Moreover, it is even more difficult to see how Russia can live with a permanently depressed oil price. Secular stagnation – the idea that a chronic shortfall of investment might produce a long period of weak demand – also has disturbing implications for financial investors. The recent high levels of equity prices were premised on the best possible of all scenarios: that productivity growth rates would revert to historical averages and that the level of gross domestic product (GDP) would eventually return to the pre-crisis economic growth trajectory. Investors have now begun to realize that neither is going to happen. GDP growth is not only slow, but also, still only close to the levels of 2007.

Neither can the share of GDP accounted for by profits go much higher. So, if productivity growth remains low, it is difficult to see how equity investments can yield significant real returns. While an easy monetary policy can boost markets over the short-term, it cannot be sustained indefinitely. In such an environment, the yields on risk-free securities will be low. With secular stagnation comes a permanent decline in inflation to levels below the desired 2% target. Therefore, the real value of public and private-sector debt will not decline as quickly as it should. In turn, this will make it more difficult for governments, companies and individuals to reduce their debt. Within such an environment, expect default rates to be high. German sovereign bunds become the only asset in the euro zone that investors regard as more or less risk free.

One would have thought that such a scenario could produce counteracting forces, a weaker exchange rate, for example. Unfortunately, that is not necessarily true. The euro zone is running a current account surplus of close to 3% of GDP this year. Normally, one would expect the currency of an economy with a persistent current account surplus to be strong. In any case, the exchange rate matters a lot more for smaller and medium-sized economies than for large ones such as the U.S. and the euro zone because the share of trade in GDP tends to be smaller for large economies than for small ones. The euro zone is a large semi-closed economy, trading most of its goods and services in euros on an internal basis. Whatever is going to save the euro zone, it cannot be the exchange rate, unless the euro depreciates to an extremely low extent.

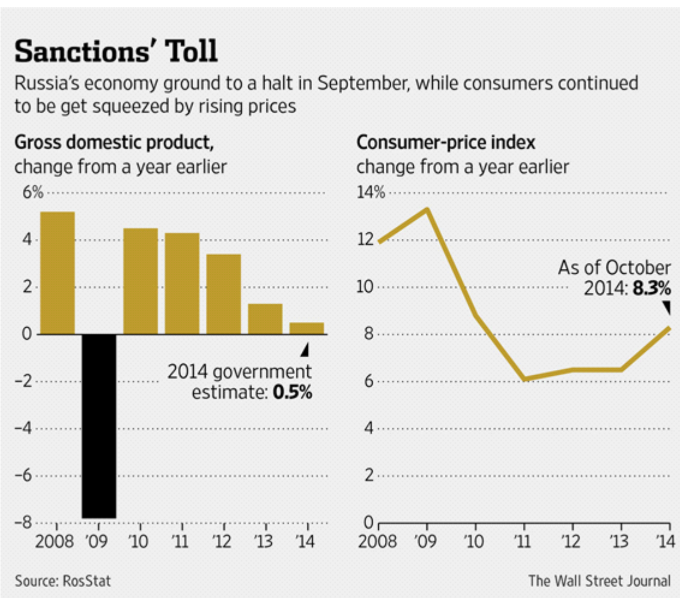
Thus, secular stagnation is a lot more dramatic than a debt crisis. With such a threat hanging over Europe, one would have thought every rational policy maker would want to avoid such a calamity. Indeed, that would be the case if the crisis occurred in a normal country. For a monetary union where policy is not co-ordinated and where policy makers adopt a national perspective, the risk of secular stagnation looms large. Even the European Central Bank (ECB), the only actor with a euro zone-wide remit, faces legal constraints. This may explain its reluctance to embrace a sizeable quantitative easing (QE) program. Even as an advocate of QE, I cannot deny that we are treading on a legally grey area.

Euro zone policy makers face three choices. They can transform the euro zone into a political union and do whatever it takes: a Eurobond, a small fiscal union, transfer mechanisms and a banking union worthy of its name. Secondly, they can just accept secular stagnation. The final choice is the break-up of the euro zone. The second and third choices are not mutually exclusive. Since the political union initiative is decidedly off the table, this leaves Europe with a choice between depression and failure, or both in succession."

WEDNESDAY, OCTOBER 22ND

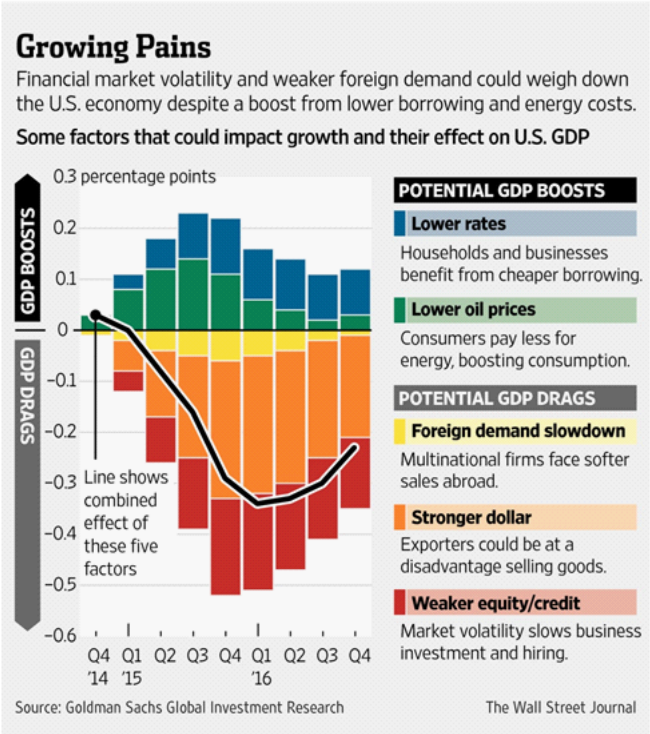
- In its monthly monetary policy update, the Bank of Canada issued a statement leaving its Bank Rate unchanged at 1%, where it has been since September 2010. Bank of Canada Governor Stephen Poloz commented: "While economic growth prospects are divergent across Canada, persistent headwinds continue to buffer most other economies where gross domestic product (GDP) growth remains highly reliant upon exceptional monetary policy stimulus."

- Front Page Headline, Wall Street Journal – "Russian Economy Stalls Amid Western Sanctions and Lower Oil Price.



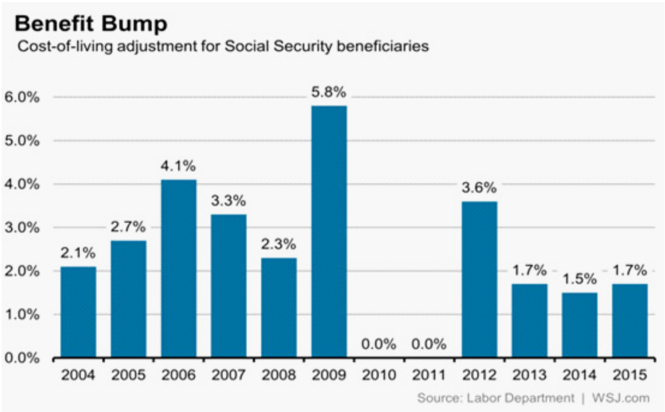
The State Statistics Service reports Russia's economy – battered by western sanctions and lower oil prices, its main export – stalled further in September even as the inflation rate reached 8.3%, its highest level for the year. Economy Minister Alexei Ulyukaev reported GDP growth was unchanged at 0.7% for the year-to-date – unchanged from August – and he did not provide a monthly figure for September. However, the outlook appears dim, because at a conference in London, Sergei Shvetsov, first deputy of the Russian central bank, noted: "Rising inflationary expectations may force the bank to seriously consider another increase in administered interest rates."

- Front Page Headline, Wall Street Journal – "Global Slowdown Threatens to Beset U.S. Economy.



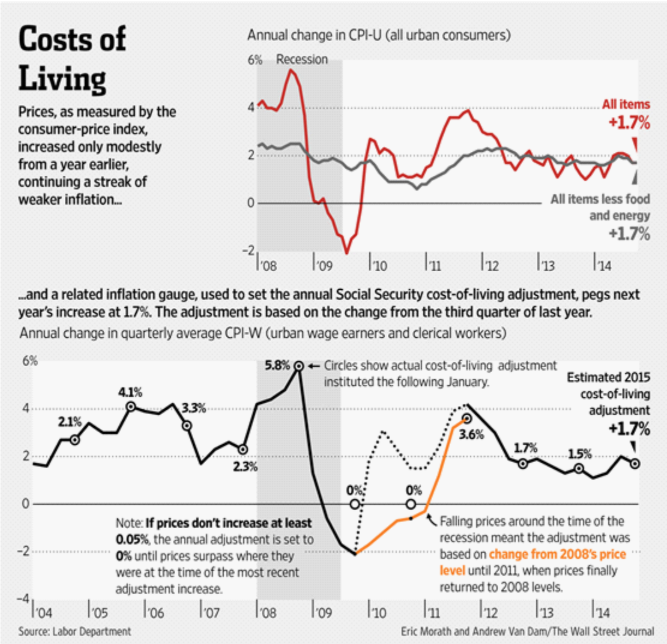
The spectre of deflation in Europe and an economic slowdown in China and other emerging markets are threatening to hobble the U.S. economy at a time when the world could use a reliable growth engine. Adolfo Laurenti, chief economist at Mesirow Financial in Chicago, warned: 'For better or worse, the U.S. is the growth engine of the global economy right now. However, with many other regions not performing, we may experience some limit regarding how much momentum we can gain."

- Front Page Headline, Wall Street Journal – "U.S. Social Security Benefits to Increase by 1.7% in 2015.



The U.S. Social Security Administration reports its annual cost of living adjustment amounts to 1.7% for 2015. The adjustment will affect nearly 64 million Americans who receive retirement and disability benefits under Social Security. Benefits rose by 1.5% this year and by 1.7% in 2013.

- The Labor Department reports the U.S. consumer price index (CPI) rose by 0.1% on a seasonally adjusted basis in September, but matched August's year-over-year rate of 1.7%. The core rate also rose by 0.1%.



THURSDAY, OCTOBER 23RD

- London-based Markit Economics reports the euro zone purchasing managers' index (PMI) for the manufacturing sector rose slightly to a reading of 50.7 in October from a level of 50.4 in September. Martin van Vliet, an economist at ING in Amsterdam, noted: "Even though the euro zone economic recovery has not ground to a complete halt, gross domestic product (GDP) growth remains much too weak for anyone's comfort."

- The Labor Department reports U.S. claims for state unemployment benefits increased by 17,000 to a seasonally adjusted 283,000 in the week ended October 18th. while continuing claims declined by 38,000 to 2.35 million in the week ended October 11th.

- Front Page Headline, Globe and Mail – "Debt-Heavy U.S. Blue Chip Companies Flash Caution Signal on Growth. Blue-chip America is bumping up against the limits to growth and financial engineering. International Business Machines Corp. (IBM), MacDonald's Corp. and Coca Cola Co. – three icons of U.S. business – all reported disappointing earnings this week and suffered painful hits to their share prices as a result. The companies' biggest issue is their inability to expand revenues in a global economy that is only trudging ahead. However, the slower growth environment is also casting a harsh spotlight on the giants' addiction to cheap credit, a strategy that may be nearing its limits. These three flagships of U.S. enterprise have helped to fuel their stock market gains in recent years by borrowing money and using it, among other things, to repurchase their shares. One advantage of this shift in the capital structure, from an investor's perspective, is that the same amount of overall earnings goes further when it is divided among a fewer number of shares.

  Since 2007, share buy backs have helped IBM and MacDonald's, in particular, to achieve impressive gains in earnings per share even though their gains on the profit front have been considerably less spectacular. However, swapping debt for equity has its limits and eventually, even the best-known businesses must find sources of true organic growth or risk having investors lose faith. Certainly, not every U.S. giant faces that same dilemma. For example, Apple reported solid growth in the 3rd. quarter, as did Boeing. However, the disappointments at IBM, MacDonald's and Coca-Cola should serve as a signal to investors that one of the dominant financial-engineering strategies of recent years is growing long in the tooth. So, if that trend continues, the outlook for corporate earnings is going to darken."

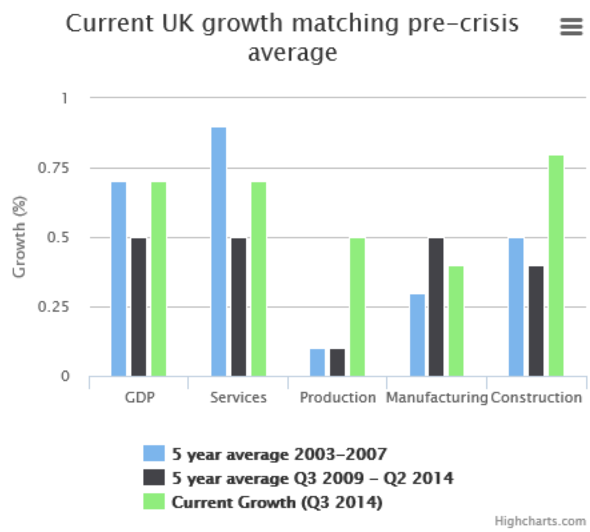
FRIDAY, OCTOBER 24TH

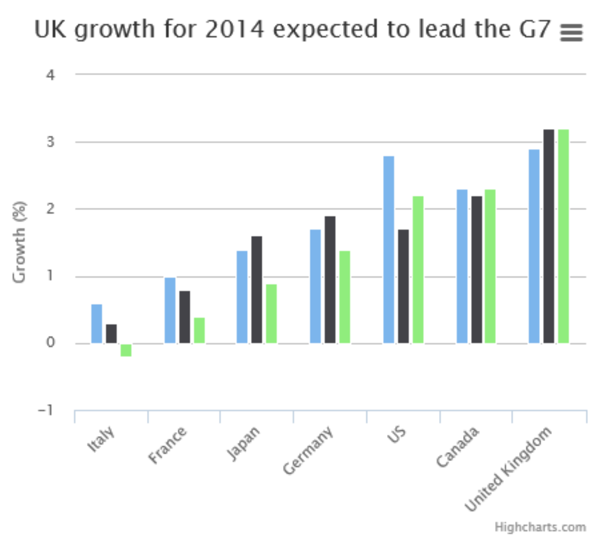
- Front Page Headline, Bloomberg News – "ECB Set To Fail 25 Banks in Stress Test. According to a draft communique of the European Central Bank's Comprehensive Assessment – the final results of which are to be released on Sunday – 105 European banks will be named as passing the review, while 25 will be deemed to fail, about 10 due to capital shortfalls."

European Central Bank President Mario Draghi.
Photo Source: Bloomberg

- The Commerce Department reports U.S. new home sales rose by 0.2% in September to an annualized pace of 467,000 units, little changed from a downwardly revised pace of 466,000 units in August.

- The Office for National Statistics (ONS) reports Britain's gross domestic product (GDP) grew by 3% in the 3rd. quarter on an annualized basis – following a 3.2% annual growth rate in the 2nd. quarter – citing weaker growth in the nation's dominant services sector. The expansion represents the 7th. consecutive quarter of positive economic growth and keeps Britain on course to be the fastest growing economy in the G7 this year. In a statement, U.K. Chancellor of the Exchequer George Osborne commented: "Today's strong GDP growth figures shows that the U.K. continues to lead the G7 pack in an increasingly uncertain global economy. With all the main sectors of our economy growing, it's clear that our domestic recovery is broadly based."





- Front Page Headline, Mineweb – "Russian Central Bank Continues Gold Buying Spree. The latest figures from Russia reveal that the country's central bank purchased another 37.33 metric tonnes of gold in September, bringing its gold holdings to almost 1,150 metric tonnes. It is the seventh consecutive month that Russia has increased its gold reserves and notably, its biggest monthly increase yet. Overall, Russia has been building its gold reserves through much of the Vladimir Putin era, i.e. since 1999. President Putin is an avowed believer in the place of gold in the global economy. The graph below from Australian gold chartist Nick Laird shows Russian gold acquisitions since 2006. There has hardly been a month since then that Russia has not added to its gold reserves.

The latest figures consolidate Russia as the world's official fifth largest holder of gold. However, China is widely believed to be approaching, or perhaps already exceeding, the holdings of number two Germany.

Table: World's top 10 gold holding nations and %age of reserves in gold

Rank	Country	Holding (tonnes)	% of currency reserves
1.	USA	8,133.5	72.1%
2.	Germany	3,384.2	67.8%
3.	Italy	2,451.8	66.7%
4.	France	2,435.4	65.2%
5.	Russia	1,149.8	10.1%
6.	China*	1,054.1	1.1%
7.	Switzerland	1,040.0	7.8%
8.	Japan	765.2	2.5%
9.	The Netherlands	612.5	54.5%
10.	India	557.7	7.1%

Source: World Gold Council, Mineweb

- Front Page Headline, Mineweb – "Higher 2013 Gold Demand and Import Totals Now Confirmed for China. In the China Gold Yearbook, we now learn, via Koos Jansen's blog, that China's wholesale gold demand was 2,199 metric tonnes in 2013 and this is further segregated into imports of 1,524 metric tonnes (in direct gold imports plus gold contained in dore bullion from foreign mines) and China's domestic gold production of 428 metric tonnes, leaving a balance of about 247 metric tonnes which must have been sourced from gold scrap and recycling. We have already been reporting that, based upon China's Shanghai Gold Exchange weekly withdrawal figures, the country's gold demand this year looks to be approaching 1,900 – 2,000 metric tonnes; a decline of perhaps 10% - 15% from 2013 … It should be stated that these Chinese gold and import figures do not include any gold bullion that may have been purchased by Chinese government agencies."

- Front Page Headline – GoldMoney – "Financial Markets Disconnected from Reality. Researcher Alasdair Macleod warns: 'Frankly, the behavior of financial markets these days is divorced from reality with value-investing banished. Financial markets have become distorted by Rumsfeld-knowns such as monetary policy and market guidance; plus Rumsfeld-unknowns such as undeclared market intervention by the authorities. Moreover, there is remote investing by computers programed with algorithms and high frequency trades, unable to make human value investments. For example, here is one instance of possible market guidance which occurred last week. On October 16th. James Dullard of the St. Louis Fed hinted that quantitative easing might be extended beyond this month. In the ensuing four trading sessions, the DJIA rallied by over 5%. Was his comment sparked by signs of slowing economic growth, or by a desire to inspire sliding equity markets? Erstwhile, there is the vested interest of maintaining government funding costs at a low level, which raises the question of whether or not exceptionally low bond yields, particularly in the euro zone, are by design or accidental.

Those who support the theory that it is all an evil plot will also note that governments and their central banks through exchange stability funds (established for the explicit purpose of market intervention), wealth funds and state pension funds have some $30 trillion (U.S.) to direct as they see fit. The reality is there is intervention across a range of markets; but most of the mispricing is in the hands of private, not government investors. For evidence, look no further than the record level of brokers' loans to equity investors, who with greed worthy of a latter-day South Sea Bubble, seek to lever up their speculative profits. These are not markets with widespread public participation, buying dotcoms and the like. Instead, ordinary investors have given their savings and pension fund monies to professionals who speculate on their behalf. It is the professionals who talk about the Yellen put, meaning the Fed simply won't allow equity prices to decline significantly. One can fret about who is actually responsible for market distortions; instead we should be asking: who benefits?

In the past, governments have covered their debts through a process dubbed financial repression, when artificially low administered interest rates and bond yields were the principal mechanisms whereby wealth was transferred from savers to governments. This process still persists today. Forget government inflation figures because when did a bank deposit net of taxes last give a positive return following a cost of living increase? Zero interest rate policies lay the process bare and turns savers into borrowers. Mr. Average has replaced savings with mortgages and car loans. So, while the elderly and other passive savers remain defenseless against financial repression, the process has taken a new twist. The transfer of wealth to governments now targets investment managers.

We now invest alongside investment funds and hedge funds, together with the banks which take our deposits and speculate on our behalf. They think that with a Yellen or Draghi put, when underwriters market a ten-year government bond with a 2% coupon, it is an attractive investment. In so doing, they are transferring financial resources to governments in a variation of old-fashioned financial repression. Our dysfunctional markets have become little more than the essential prerequisite – as Louis XIV's finance minister Colbert might have said – to plucking the goose for the largest amount of feathers with a minimum of hissing.

CLOSING LEVELS FOR FRIDAY, OCTOBER 24TH.		WEEKLY CHANGE
Dow Jones Industrial Average	16,805.41	+ 425 points
Spot Gold Bullion	$1,231.80 (U.S.)	– $7.20 per troy oz.
Spot Silver	$17.19 (U.S.)	– $0.09 per troy oz.
S&P / TSX Composite	14,543.82	+ 316.14 points
10 – Year U.S. Treasury Yield	2.27%	+ 8 basis points
Canadian Dollar	89.02 cents (U.S.)	+ 0.34 cent
U.S. Dollar Index Future	85.705	+ 0.396 cent
WTI Crude Oil Futures	$81.01 (U.S.)	– $1.74 per barrel
DJIA / Gold Ratio	13.64	+ 0.42 point
Gold / Silver Ratio	71.66	– 0.04 point

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