Monday October 27th, 2014

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

Monday, October 27th

Front Page Headline, Bloomberg News – "Only 8 EMU Banks Fail ECB Stress Test. Of the 25 European banks expected to fail the European Central Bank's balance sheet Asset Quality Review, only 8 were deemed to fail, in the final analysis, as having

MONDAY, OCTOBER 27TH

capital shortfalls. To pass the adverse stress test – which scrutinized bank loans as at December 31, 2013 – European Monetary Union banks needed common equity Tier 1 capital equivalent to at least 8% of risk-weighted assets, for which the pass mark was 5.5%. Of the 8 bank failures, four were Italian, including Siena-based Banca Monte dei Paschi which was told to raise another 2.11 billion euros."

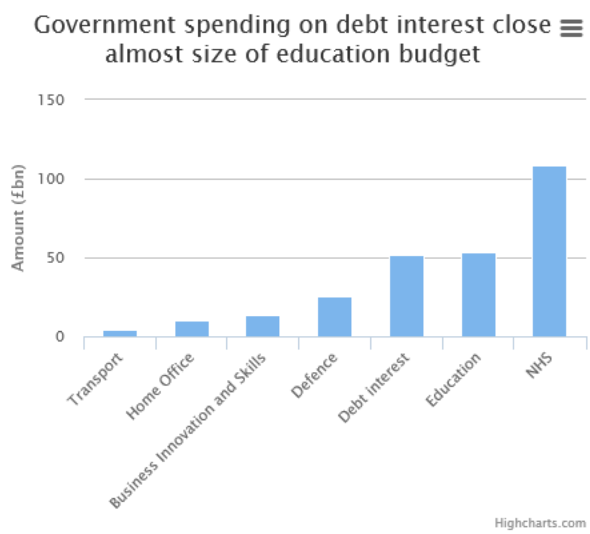
Source: Wall Street Journal

- The Washington-based National Association of Realtors (NAR) reports its U.S. pending home sales index rose by a seasonally adjusted 0.3% to a reading of 105 in September, following a decline of 1% in August. Ian Shepherdson, chief economist at Pantheon Macroeconomics in White Plains, New York, commented: "While we see few signs of further sales momentum at present, we are hopeful that the recent decline in mortgage rates, coupled with the continuing improvement in the labor market, will trigger at a modest renewed upturn by the end of the year."

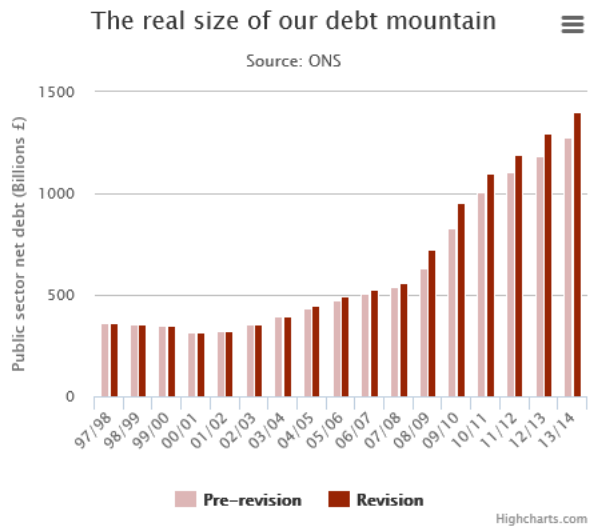
- The Munich-based Ifo Institute for Economic Research reports its German business climate index – based upon a survey of 7,000 German executives – declined to a reading of 103.2 in October from a level of 104.7 in September, representing the 6th. consecutive monthly decline and the lowest level since December 2012. Georg Kraemer, chief economist at Commerzbank AG in Frankfurt, warned: "The latest numbers from the industrial sector are very worrisome. Gross domestic product (GDP) performance in the 3rd. quarter was probably worse than we expected; at best the economy may have stagnated."

- Front Page Headline, Daily Telegraph U.K. "Britain's Huge Debt Pile Poses Risk to U.K. Economic Recovery. In a letter to Britain's Chancellor of the Exchequer George Osborne, the Institute of Chartered Accountants in England and Wales (ICAEW) highlighted that the government was already spending about 1 billion pounds a week servicing the nation's outstanding debt. ICAEW warned: 'With many departmental budgets the size of FTSE 100 companies, revenues, expenditures, balance sheet management and cash flow; all need to be tightly managed.' ICAEW's Chief Executive Officer Michael Izza added: 'Now more than ever, the Chancellor cannot take his eye off the ball when it comes to the country's debt and public finances. Tempting as it may be, he must avoid any short-term political land grabs and instead, focus on practical measures which will help secure our economic recovery.'

At 52.1 billion pounds this year, debt servicing costs are projected to be higher than the day-to-day spending budgets of the Business, Innovation and Skills and Defense Departments combined and almost as much as the Education budget. The Office for Budget Responsibility (OBR) has forecast that debt interest payments will increase to 75.2 billion pounds by the end of the 2019 fiscal year. Moreover, British Prime Minister David Cameron has pledged to raise the tax-free allowance to 12,500 pounds from 10,500 pounds by 2020 and the threshold for the 40% income tax rate to 50,000 pounds from 41,000 pounds if the Tories win the next general election. However, ICAEW's Mr. Izza has warned: 'We don't think the Chancellor of the Exchequer has leeway in the public finances to be radical in the Autumn Statement.'



The ICAEW also stated: 'In addition, we are calling on the government to rethink its plans to enable the taxman to raid people's bank accounts. Such a move would have the unintended effect of undermining public confidence in Her Majesty's Revenue and Customs (HMRC) even further. Instead of creating new draconian powers, the government should focus on fast tracking this process to ensure it is timely and cost effective.' The British Bankers' Association, which represents the country's biggest lenders, has already written to the Chancellor, warning: 'HMRC is not sufficiently competent to be trusted with such powers." See chart below from the U.K. Office of National Statistics (ONS).



- Front Page Headline, Mish's Global Economic Trend Analysis – "Chinese Home Price Decline Spreads. The National Bureau of Statistics reports China's home prices declined in 69 of 70 cities in September, the most since January 2011, when the government changed its method of data compilation. On September 30th. the People's Bank of China (PBOC) eased mortgage rules for homebuyers who have paid off existing loans, reversing course after a four year campaign to contain homes prices, as Premier Li Keqiang seeks to prevent domestic economic growth from drifting too far below the government's 7.5% annual target. In a recent report, Shenzhen-based analyst Yang Kan wrote: 'Developers will keep prices attractive as they open more projects towards the end of the year to meet sales targets, boosting supply and increasing competition.' The PBOC's new rules give homeowners, who have paid off their mortgages and want a second property, the same advantages as first-time buyers; including a 30% minimum down payment – compared to about 60% previously – and mortgage rate discounts up to 30% off the central bank's benchmark rate."

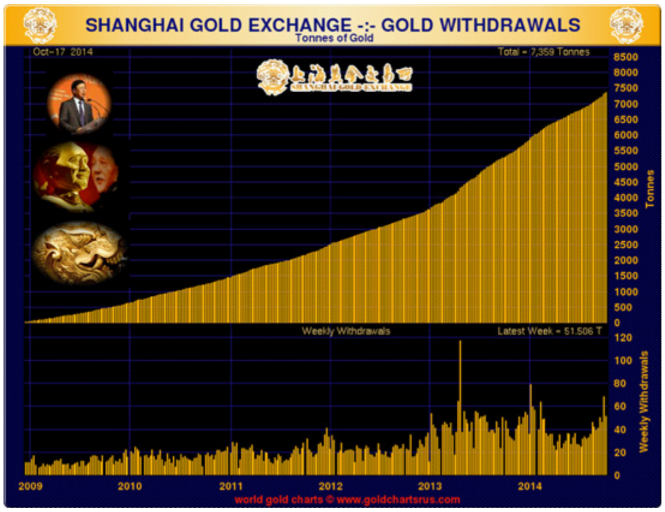
TUESDAY, OCTOBER 28TH

- The New York-based Conference Board reports its U.S. consumer confidence index rose to a reading of 94.5 in October – a 7-year high – following a level of 89 in September. Michael Moran, chief economist at Daiwa Capital Markets America in New York, noted: "It would appear as though we will experience an extended period of lower energy prices, which is boosting confidence and will provide individuals with a little more discretionary income; so it's a clear plus for the domestic economy."

- The Commerce Department reports U.S. durable goods – items expected to last at least three years – orders declined by 1.3% in September, following an 18.3% drop in August.

- The S&P / Case Shiller group reports its composite index of property prices for 20 U.S. cities rose by 5.6% in August on a year-over-year basis, the lowest annual increase since November 2012.

- Front Page Headline, Mineweb – "Significant Increase in Hong Kong Gold Exports to China.

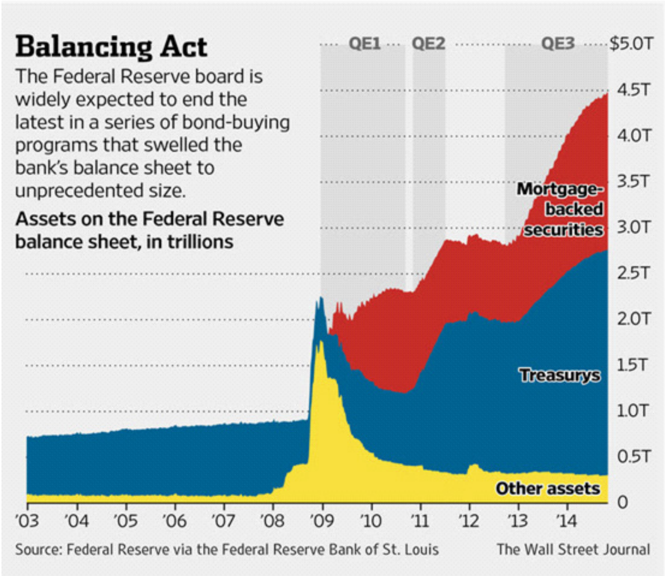


This year, Hong Kong export figures and Shanghai Gold Exchange (SGE) withdrawals have tended to move ever further apart since import restrictions have eased, making other ports of entry for imported gold far more significant. Unfortunately, China does not publish these specific import figures, however, the SGE does publish weekly gold withdrawal data which reveals a decidedly more accurate indicator of actual Chinese gold demand. The SGE gold withdrawal figures from September tell rather a different story still. They place Chinese wholesale gold demand at about 175 metric tonnes which if one subtracts China's own gold output of some 37 metric tonnes a month, leaves total Chinese mainland imports at about 123 metric tonnes, double the Hong Kong figure. Perhaps, what is more interesting for China gold watchers is that transactions seem to have increased further since the beginning of October; with the five days around the Golden Week holiday seeing gold withdrawals from the SGE of a massive 68 metric tonnes and the following week a further 51 metric tonnes. Given that global mine supply is only about 56 metric tonnes, that puts the level of Chinese demand into real perspective.

So, the SGE withdrawals for the year up until mid-October total some 1,544 metric tonnes, this representing about 70% of global mine production just from one country and the figure for China may well be higher still, if as most now believe, the Bank of China is also buying gold under the radar. Indian demand for gold is also surging, having exceeded 90 metric tonnes in September. With the festival season having just begun with Diwali last week, gold sales have continued to increase to the extent that they are again causing current account deficit problems for the government. Also, gold smuggling in India appears to be on the rise again since the government has refrained from relaxing its stringent import restrictions any further. If China and India were the only countries importing gold, that would still be a problem in terms of balancing the supply / demand equation this year; but they are not … Central banks in other countries are still gold buyers, with perhaps up to 450 metric tonnes being purchased this year. Indeed, all indicators suggest that there could be a very large supply deficit building. While we don't know how long this imbalance can continue, it does influence our view regarding the long-term price for gold bullion."

WEDNESDAY, OCTOBER 29TH

- Front Page Headline, Bloomberg News – "As Planned, FOMC Ends QE Program. As expected, The Federal Open Market Committee in Washington announced it will be ending its current Quantitative Easing program on October 31st. with a balance sheet totaling $4.5 trillion (U.S.) comprised of U.S. Treasurys and mortgage-backed securities. The FOMC cited: 'Domestic labor market conditions have improved somewhat further with solid job gains and a lower unemployment rate.



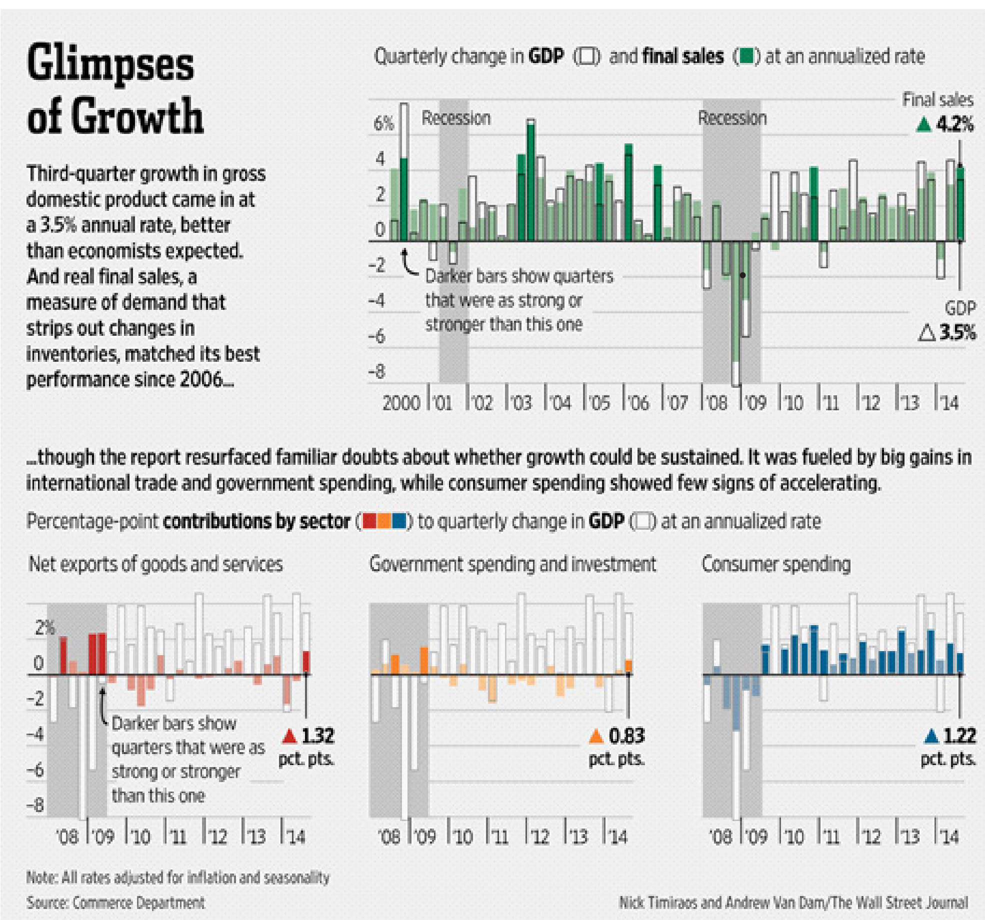
While a range of labor market indicators suggests that underutilization of labor resources is gradually diminishing, the FOMC will not only be maintaining its commitment to keep administered interest rates (Federal Funds Rate)low for a considerable time, but also, its policy of reinvesting maturing proceeds."

THURSDAY, OCTOBER 30TH

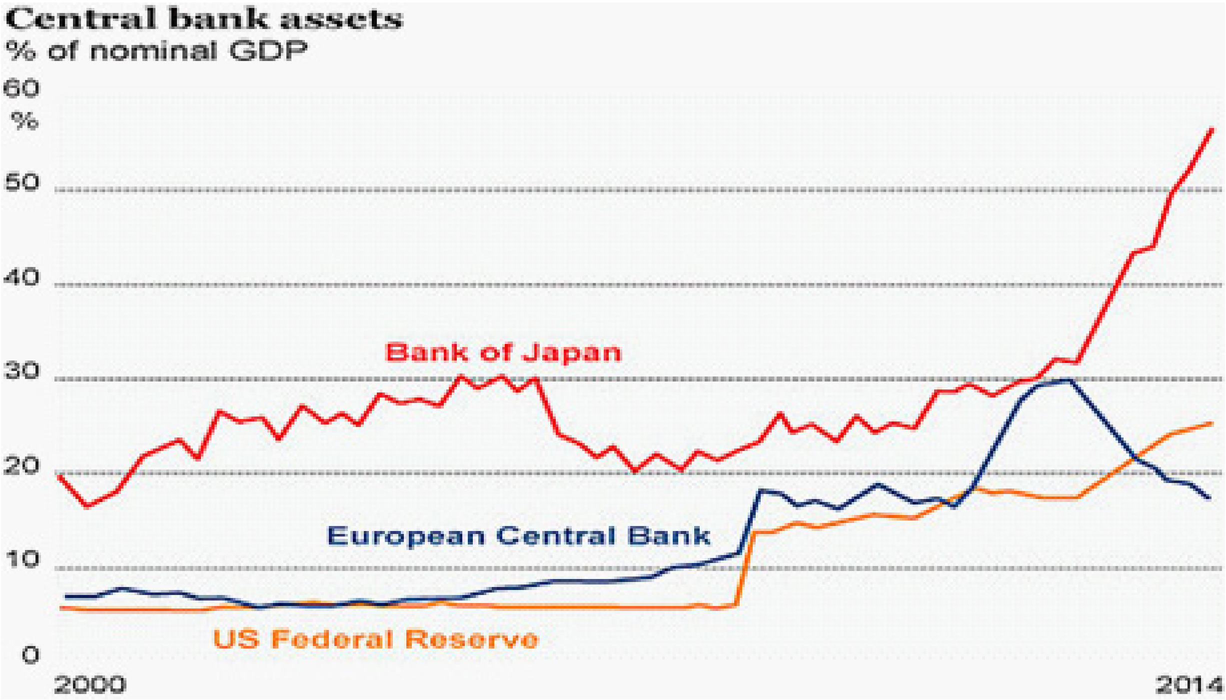
- The Commerce Department reports the U.S. gross domestic product (GDP) grew at an annual rate of 3.5% in the 3rd. quarter following a 4.6% pace in the 2nd. quarter. Brian Jones, an economist at Societe Generale in New York, observed: "The domestic economy is on a firm footing and if the labor market continues to improve, that will provide the primary support for consumer spending." Separately, the Commerce Department reported U.S. initial claims for state unemployment benefits increased by 3,000 to 286,000 in the week ended October 26th. while continuing claims rose by 29,000 to 2.38 million in the week ended October 18th.

FRIDAY, OCTOBER 31ST

- The University of Michigan / Thomson Reuters group reports its U.S. consumer sentiment index rose to a final October reading of 86.9 – the highest level since July 2007 – following a final September reading of 84.6.
- Statistics Canada reports the nation's gross domestic product (GDP) declined slightly by 0.1% in August, but maintained a 2.2% growth rate on a year-over-year basis.
- MNI Indicators reports the Chicago-area purchasing managers' index (PMI) for the manufacturing sector rose to a reading of 66.2 in October, following a level of 60.5 in September, citing the new orders component made a dramatic upward bounce to a reading of 73.6.



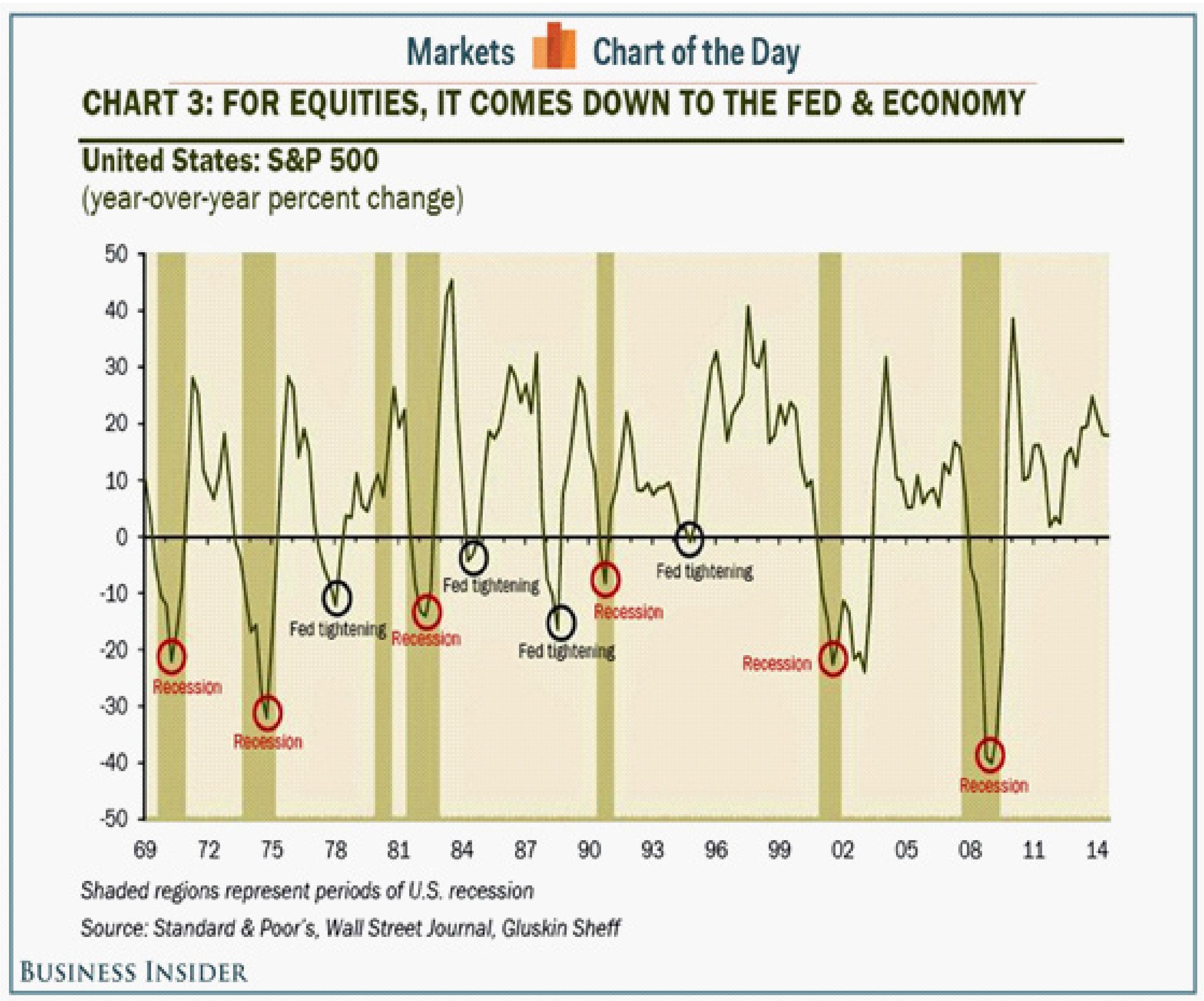
- Front Page Headline, Daily Telegraph U.K. – "Japan Risks Asian Currency War with New QE Program. International Business Editor Ambrose Evans-Pritchard writes: The Bank of Japan (BOJ) has jolted global financial markets with a new stimulus initiative, pushing quantitative easing to unprecedented levels in a bid to drive down the yen and avert a relapse into deflation. The announcement ignited a euphoric rally on global equity markets, but the economic consequences may be less benign. Critics believe it threatens a trade shock across Asia in what amounts to currency warfare, risking serious tensions with China and Korea and tightening the deflationary noose on Europe. In a hotly-contested decision, the Bank of Japan voted to increase its asset purchases by 25% to approximately $700 billion (U.S.) a year, covering the fiscal deficit and the lion's share of Japan's annual budget. Marc Ostwald at Monument Securities noted: 'They are monetizing the national debt even if they refuse to admit it.' In a telling move, the BOJ will concentrate new firepower on Japanese Government bonds (JGBs), extending the average maturity date out to between seven and ten years. The BOJ also pledged to triple the amount which will be directly injected into the Tokyo stock market through exchange-traded funds, triggering a 4.3% surge in the Topix Index. BOJ Governor Haruhiko Kuroda vowed: 'The new stimulus program is intended to preempt mounting deflation risks in the world and we will do whatever it takes to lift inflation to 2% via Japan's Abenomics revolution. We are at a critical moment in our efforts to break free from our deflationary mindset.' The unstated purpose of Mr. Kuroda's reflation drive is to lift nominal gross domestic product (GDP) growth to 5% a year. The finance ministry deems this the minimum level needed to arrest a public debt of 245% of GDP from spinning out of control. The intention is to erode the debt burden via a combination of higher GDP growth and negative real interest rates, a de facto tax on savings … Marcel Thielient at Capital Economics noted: 'The BOJ already owns 25% of all Japanese state bonds and 33% of all short-term notes. Henceforth, its balance sheet will increase by 1.4% each month, i.e. three times the previous pace of QE by the U.S. Federal Reserve. There is little chance the BOJ will meet its 2% inflation target by early next year, illustrating just how difficult it is to generate lasting price increases once deflation has become lodged in an economy … As each country resorts to a beggar-thy-neighbour policy in moves akin to the 1930s, deflation is dumped into the lap of any region which is slow to respond – currently the euro zone … Japan must move carefully. The world turned a blind eye to the currency effects of Mr. Kuroda's first round of QE because the yen was then seriously overvalued. This is no longer the case. The risk for Premier Shinzo Abe is that further bursts of stimulus may be taken by critics as an admission of failure, although in reality it is far too early to judge whether the country has closed the chapter on its two lost decades. What seems certain is that Japan was sliding headlong into a debt compound trap before Mr. Abe launched his 'hail Mary' pass into the unknown."



Source: Daily Telegraph U.K.

- Front Page Headline, Business Insider – "Bear Stock Markets Don't Just Happen Indiscriminately: Rosenberg. In a recent Business Insider interview, Gluskin Sheff Economist David Rosenberg was asked what he considered to be the main causes of equity bear markets. Mr. Rosenberg replied: 'For stocks, it always comes down to the Fed and the economy. The reality is that bear stock markets do not just pop out of the air. They are caused by tight monetary policies, economic recessions, or both. These conditions neither apply at the present time, nor will they until 2016 at the earliest. Based upon the trends in the Conference Board's Leading Economic Indicator, a recession is at least two years away. That is one peg, i.e. the economic expansion being sustained. The other is Federal Open Market Committee monetary policy and any administered interest rate hikes now seem to be more of a 2015, rather than a 2016 story." See chart below.

- At Longwave Analytics, we would disagree with Mr. Rosenberg that FOMC implementation of a tighter monetary policy will likely cause the next economic recession in the United States. Rather, we believe that inexorable global debt growth will lead to developed economies, initially such as in Japan and Italy, being unable to service their outstanding sovereign debt without creating even more debt. For example, America's national debt is rapidly approaching $18 trillion (U.S.). Indeed, higher bond yields and administered interest rates would only serve to exacerbate the debt problem further. Many economists in the United States and Japan, for example, believe that their economies can grow their way out of debt. Realistically, we believe there is no chance of that scenario unfolding. See also, Economic Winter, It's Still the Debt, Stupid – March 21, 2014.



CLOSING LEVELS FOR FRIDAY, OCTOBER 31ST.		WEEKLY CHANGE
Dow Jones Industrial Average	17,390.52	+ 585.11 points
Spot Gold Bullion	$1,171.60 (U.S.)	– $60.20 per troy oz.
Spot Silver	$16.14	– $1.05 per troy oz.
S&P / TSX Composite	14,613.32	+ 69.50 points
10 – Year U.S. Treasury Yield	2.34%	+ 7 basis points
Canadian Dollar	88.72 cents (U.S.)	– 0.30 cent
U.S. Dollar Index Future	86.915	+ 1.21 cents
WTI Crude Oil Futures	$80.54 (U.S.)	– $0.47 per barrel
DJIA / Gold Ratio	14.84	+ 1.20 points
Gold / Silver Ratio	72.59	+ 0.93 point

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