Monday September 1st, 2014

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

Monday, September 1st

Markit Economics reports its purchasing managers' index (PMI) for the euro area declined to a reading of 50.7 in August from a level of 51.8 in July. Separately, Germany's PMI fell to a reading of 51.4 in August from 52.4 in July; while Italy's PMI dropped to a

MONDAY, SEPTEMBER 1ST

Labour Day Holiday in Canada and the United States

reading of 50.7 in August from a level of 51.8 in July. Separately, Germany's PMI fell to a reading of 51.4 in August from 52.4 in July; while Italy's PMI dropped to a reading of 49.8 from 51.9 in the same time frame. Sentiment across Europe has been negatively impacted by the conflict between Ukraine and Russia, undermining corporate spending and investment. Howard Archer, an economist at IHS Global Insight in London, commented: 'Euro zone manufacturers are clearly finding business very difficult at the moment. This heightened geopolitical uncertainty has affected both business and consumer confidence; which is likely causing some manufacturing orders to be delayed or even cancelled.'

- Front Page Headline, Bloomberg News – "Spain Markets First 50-Year Sovereign Bond Issue. The Spanish government is taking advantage of the narrower spreads along the yield curve by issuing a one billion euro ($1.3 billion U.S.) private placement of bonds on a 4% yield basis, to mature on October 1, 2064. David Nautz, a fixed income strategist at Commerzbank AG in London, noted: 'This issue definitely fits into the stretch-for-yield environment. Bond investors had to, not only move down on the sovereign credit rating scale, but also, move well out on the yield curve. The issue's 4% coupon is exactly what German life insurance companies must exceed in terms of nominal yield for some legacy life insurance policies, so both the coupon and the maturity date appear tailor-made for them."

- Finance Canada reports the federal government posted a surplus of $1.6 billion (CAD) in June, compared to a $200 million (CAD) surplus in the same month a year ago. The Finance Department cited the increase resulted due to higher revenues from non-resident income taxes, excise taxes and duties. For the April-to-June period, the federal government posted a surplus of $400 million (CAD), compared with a deficit of $2.6 billion (CAD) in the same period a year ago. In the autumn, Canadian Finance Minister Joe Oliver is expected to provide an update of the economic and fiscal outlook for the balance of the fiscal year ending March 31, 2015.

- Front Page Headline, Financial Times – "Israel Undertakes Largest West Bank Land Appropriation in 30 Years. Yesterday, Israel announced it was appropriating a large swath of land in the occupied West Bank, near the area where three Jewish boys were killed in June by Palestinians affiliated with Hamas; in an event that basically triggered the recent 50-day war in the Gaza Strip. Some 400 hectares (990 acres) –near the Gush Etzion settlement bloc near Bethlehem – was declared state land by Israel's military-operated Civil Administration, in what an anti-settlement group termed the biggest appropriation of Palestinian land in three decades. Xavier Abu Eid, a spokesman for the Palestine Liberation Organization's (PLO) negotiations department, reacted: 'It shows once again that this Israeli government is not interested in peace. What has happened in Gaza and what is happening in the West Bank are both part of the same policy: to deny Palestinian rights."

- Front Page Headline, Wall Street on Parade – "The Exponential Growth in Dark Pool Trading. Investor concern has grown significantly, as dark pool trading data has become available – for the first time ever – by the Financial Industry Regulatory Authority (FINRA), Wall Street's self-regulator. A dark pool is an unregulated stock exchange which does not make bids and offerings on stocks transparent to the marketplace; a venue ripe for manipulation. Week after week, FINRA data reveals that Wall Street's biggest banks are trading each other's stocks in their own dark pools. Inexplicably, the banks are being allowed to trade their own corporate parent's stock in their dark pools. How this is compatible with the anti-manipulation statutes of the Securities Exchange Act of 1934 has yet to be explained. The most unsettling aspect of all this is that the dark pool framework relies on the theory that global investment banks can be trusted to operate unregulated stock exchanges, swapping millions of shares of each other's stocks with no oversight and no transparency. However, there is a zero basis for that trust. These are the same banks which are being charged, month after month, year after year, with cavalierly engaging in collusion with each other in order to rig market benchmarks for their own self-enrichment and to the extreme detriment of market integrity, small investors and the economy at large … In order to restore public confidence which seems to have permanently left our markets, investors need a credible, non-conflicted and independent counsel to preside over any investigations."

TUESDAY, SEPTEMBER 2ND

- The Tempe, Arizona-based Institute for Supply Management (ISM) reports its index for U.S. manufacturing rose to a reading of 59 in August, following a level of 57.1 in July, citing a surge in orders for metals and plastic products. Bradley Holcomb, who oversees the survey for the ISM, stated: "Seventeen of the eighteen industries surveyed reported activity growth during August, so this strength is broadly based."

- RBC reports its purchasing managers' index (PMI) for the Canadian manufacturing sector rose to a reading of 54.8 in August, following a level of 54.3 in July. The index is based upon a monthly survey of new orders, output, employment and stock of items purchased. RBC Chief Economist Craig Wright observed: "With the index registering its 9th. consecutive month of improvement, the momentum in Canada's manufacturing sector is clearly directly benefiting from a strengthening U.S. economy; as well as the domestic economy."

WEDNESDAY, SEPTEMBER 3RD

- The Commerce Department reports U.S. factory orders rose by 10.5% in July, led by a surge in contracts for commercial aircraft, following a revised increase of 1.5% in June, previously reported as a gain of 1.1%.

- Front Page Headline, Globe and Mail – "Bank of Canada Monetary Policy Remains in Neutral. In a statement following its regularly scheduled monetary policy meeting, Bank of Canada Governor Stephen Poloz asserted: 'While an increasing number of export sectors appear to be turning the corner toward recovery, this trend must be sustained before it will translate into increased business investment and hiring … Overall, the risks to the outlook for inflation remain roughly balanced, while the risks associated with household imbalances have not diminished. The balance of both these risks is still within the zone for which the current stance of monetary policy is appropriate.' Accordingly, the central bank left its Bank Rate set at 1%." CIBC World Markets Economist Avery Shenfeld observed: 'The Bank of Canada's key message is that the next move in the Bank Rate could be either up or down, largely because it is seen as distant enough to be uncertain in either timing or direction."

Bank of Canada Governor Stephen Poloz.
Source: Globe and Mail

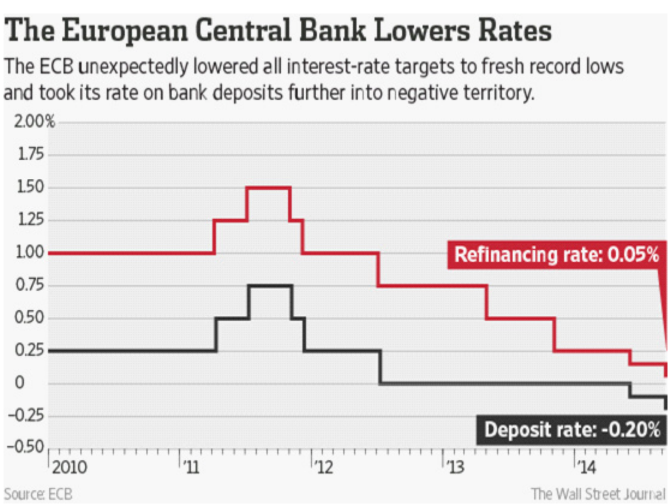
- In its latest Beige Book report of anecdotal information on business activity from industries across America, the Federal Reserve noted that six of its twelve districts reported economic growth as "moderate, with the auto industry showing strong growth, as well as improving banking conditions … Labor market conditions, as measured by hiring trends, were reported to be relatively unchanged from generally modest rates in most districts. However, nearly all the districts reported difficulties finding certain types of skilled labor; citing information technology, truck drivers and construction workers as some of the occupations with shortfalls."

- Front Page Headline, Business Insider – "The World's 27 Most Competitive Countries: WEF. The World Economic Forum has released its annual report of the world's most competitive economies. The WEF report ranks these economies on the '12 pillars of competitiveness:' institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, financial market development, technological readiness, market size, innovation and business sophistication. The WEF report identified: 'Intelligent investment in skills and innovation is key to enhanced productivity and competitiveness. This also supports more inclusive economic growth by allowing everyone to contribute to and benefit from higher levels of prosperity. Economies which consistently rank high in the competitiveness rankings are those which are able to develop, attract and retain talent, while constantly introducing new and higher value-added products and services into the marketplace.'

In reviewing 144 economies, the WEF ranked Canada in the 15th. spot: 'Canada ranks 7th. for health and primary education, 7th. for labor market efficiency and 8th. for financial market development.'

THURSDAY, SEPTEMBER 4TH

- Front Page Headline, Bloomberg News – "ECB Cuts Interest Rates and Begins Purchasing Securities. At a Frankfurt press conference, European Central Bank President Mario Draghi announced: 'The ECB will purchase a broad portfolio of simple and transparent securities. In taking this step, our Governing Council sees the risks to the EMU economic outlook on the downside, witness the recent weakening in the growth momentum of the gross domestic product (GDP).' Simultaneously, the Governing Council voted to reduce both of its main interest rates by 10 basis points. Its benchmark refinancing rate was lowered to 0.5% and its deposit rate was reduced to minus 0.2%. Ten basis points is the equivalent of 1/10 of 1%."



- Statistics Canada reports the nation posted a merchandise trade surplus of $2.6 billion (CAD) in July, after a revised surplus of $1.8 billion (CAD) in June and led by higher exports of machinery, autos and forest products.

- Front Page Headline, Bloomberg News – "BP Negligence Ruling May Force Billions in Additional Fines. U.S. District Judge Carl Barbier has ruled that 'BP Plc employees took risks which led to the largest environmental disaster in U.S. history.' U.S. Attorney General Eric Holder remarked: 'The court's ruling will ensure that BP is held fully accountable for its recklessness. This decision will serve as a strong deterrent to anyone tempted to sacrifice safety and the environment in pursuit of profit."

U.S. Coast Guard fireboats battle the blazing remnants of the BP offshore oil rig Deepwater Horizon on April 21, 2010 near New Orleans, Louisiana   Source: Bloomberg files

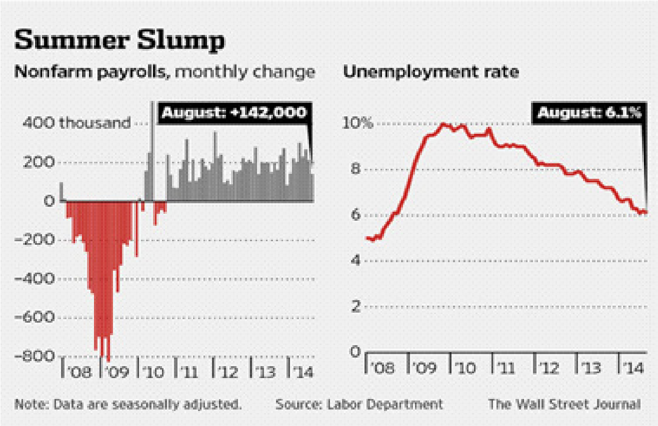
- The Tempe, Arizona-based Institute for Supply Management (ISM) reports its U.S. non-manufacturing index rose to a reading of 59.06 in August, following a level of 58.7 in July. Laura Rosner, an economist at BNP Paribas in New York noted: "We've not yet seen if this is self-reinforcing with respect to consumption, because I think there are headwinds still weighing on consumers."

- The Labor Department reports U.S. initial claims for state unemployment benefits increased by 4,000 to a seasonally adjusted 302,000 in the week ended August 30th. while continuing claims declined by 64,000 to 2.46 million in the week ended August 23rd. Separately, the Roseland, New Jersey-based ADP Research Institute reports private employers added 204,000 workers to their payrolls in August, after a 212,000 gain in July.

- The Commerce Department reports America's trade deficit narrowed slightly to $40.5 billion (U.S.) in July, following a deficit of $40.8 billion (U.S.) posted in June. Exports rose by 0.9% to a record high $198 billion (U.S.), led by a surge in demand for automobiles, auto parts and engines.

FRIDAY, SEPTEMBER 5TH

- The Labor Department reports U.S. non-farm payrolls increased by a seasonally adjusted 142,000 in August – the fewest of any month this year – while the official unemployment rate declined to 6.1% from 6.2%. The labor participation rate, which indicates the percentage of working age people in the labor force, declined slightly by 0.1% to 62.8%, matching the lowest level since 1978. Diane Swonk, chief economist at Mesirow Financial in Chicago, noted: "The disappointing payroll number enables central bank Chairwoman Yellen to carry out her plan to end Fed tapering in October and refrain from raising the Fed Funds rate anytime soon."



- Statistics Canada reports the nation's private sector shed 11,000 jobs in August, citing: "employment levels in the private sector have been relatively flat since the fall of 2013." Moreover, the nation's labour participation rate declined to 66%, the lowest level since 2001.

- Front Page Headline, Daily Telegraph U.K. – "ECB Launches a Monetary Policy Smokescreen. International Business Editor Ambrose Evans-Pritchard writes: 'As always, ECB President Mario Draghi has played a weak hand with skill. He is a superb actor. Yet the package of measures unveiled by the ECB yesterday is pitifully small and mostly window dressing; an effort to buy time with a mixture of vague gestures and outright gimmicks, substitutions for decisive action. Andrew Roberts, a credit analyst at the Royal Bank of Scotland, concluded: 'There is huge smoke and mirrors at the time of the announcement, however, when one peruses the figures 24 hours later, you realize it is nothing like what you first thought.' While the delirious reaction of market traders is interesting, essentially it is just noise. As Christian Schultz at Berenberg Bank observed: 'The latest interest rate cuts are a screen to paper over divisions.' In other words, the ECB could not secure German political consent for a genuine reflation initiative, so it acted out a pantomime instead.

The new ECB measures add little to what was already placed on the table in June. Some are marginally helpful, some trivial, with a shocking lack of detail about the one point that really matters. The ECB had years to plan a quantitative easing program (securities / asset purchases), yet Mr. Draghi dodged all questions about the scale. One might conclude that there is still no real EMU agreement on the course of action. Small wonder, since Germany's member of the ECB board – Sabine Lautenschlaeger – stated only two months ago that 'QE is unthinkable except in an emergency' and no such emergency exists. By default, the ECB is making the same mistake as the Bank of Japan did in its dog days; i.e. trying to buy time with half measures, hoping that the global economic recovery will lift Europe off the reefs without anything being done. While the ECB may get away with this, there remains a very high risk that instead, Europe will remain trapped in mass unemployment, with ever rising debt ratios.

ECB overall monetary policy settings remain contractionary. Not only are both monetary policy and fiscal policy too tight, but also, banking regulations are too tight. In point of fact, little is being done to stop a deflationary psychology taking hold across half of Europe. Nobel laureate Joe Stiglitz has warned of a depression lasting through most of the current decade. Mr. Draghi has stated that he hopes to 'significantly stir' the ECB's balance sheet back towards the levels of 2012 (3.1 trillion euros). That dictates a one trillion euro boost and there begins the first big confusion. Much of this will be in the form of cheap loans to banks in exchange for collateral. As the International Monetary Fund (IMF) alluded earlier this summer, this plan is not remotely akin to quantitative easing. The ECB would not be taking the risk on its own balance sheet. The monetary mechanism is entirely different and far less powerful.

The original 1 trillion euros of loans in early 2012 were a lifesaver because the EMU was then in a financial crisis and they stabilized the system for a short time. However, the euro zone is now facing a different problem. It is in a chronic deflationary malaise, a bad equilibrium. Households are paying down debt and demand for credit is muted. In July, Mr. Draghi himself suggested that the forthcoming loan auctions could reach 1 trillion euros in various forms; from which one must subtract repayments from the old loans. Nick Matthews, an analyst at Nomura Securities, calculates that the actual purchases of asset-backed securities, mortgage-backed securities and covered bonds is likely to total 450 billion euros, although others suggest it might be even lower. This program would be spread over three years, a mere 12.5 billion euros per month. This is derisory and will not even commence until the end of the year. All the evidence indicates that QE works via a critical mass effect. It must be carried out swiftly and with maximum force to break out of the vicious circle. Marcel Fratzscher from Germany's DIW Institute has called for 60 billion euros of sovereign bond purchases monthly, equal to 0.7% of total EMU sovereign debt and roughly in line with moves by the U.S. Federal Reserve. The Bank of Japan is buying about 55 billion euros worth of assets each month to defeat deflation. This is equal to 140 billion euros of monthly purchases in the euro zone on a GDP ratio basis, ten times more powerful than what the ECB is discussing.

Nor is it clear how much the ECB can really do since Mr. Draghi made a throw away comment that the central bank would only purchase 'high quality' assets. RBS' Andrew Roberts exclaimed: 'It's absolutely pointless. There is no point in bothering if they are not going to take any of the poorer quality holdings off banks' balance sheets.' Regarding the 10 basis point cut in the refinancing interest rate to 0.5%, it will make no difference, beyond ensuring that banks show up to bid at the first loan auction later this month rather than waiting until December. Michael Kemmer at the German BDB banking federation says the impact will be 'negligible.' Georg Fahrenschon from Germany's savings bank association labeled the plan 'interest rate cosmetics' and warned: 'the ECB's latest mini steps will achieve nothing.' They merely underscore the fact that the ECB has shot its bolt. Liane Buchholz from Germany's association of public banks compared the program to 'a late summer sale,' doubting that it would do anything to entice euro zone banks to assume more risk. How could it do so since new rules and higher capital adequacy ratios are still forcing lenders to deleverage, in some cases with manic determination?

The cut in the discount rate to minus 0.2% is clearly intended to drive down the euro, so far successfully. However, it is a hazardous strategy, which is why the U.S. Federal Reserve and the Bank of England never went this far. Much of Europe's 900 billion euro money market industry is sliding under water. We can expect an exodus over the next two months as maturities occur. The ECB is twisting itself into knots, undertaking ever more complicated operations because it will not bite the bullet and launch plain vanilla quantitative easing; a one trillion euro blitz of sovereign bond purchases, commencing immediately. It is choosing not to do this because Germany has a de-facto veto and all parties are aware that there will be a challenge filed at the German Constitutional Court the moment any such action is taken. However, this is not a criticism of Germany. I entirely agree with German patriots who say that QE is fiscal union by the back door and an assault on the budgetary prerogatives of the Bundestag; an evisceration of German democracy. It is a criticism of the irredeemably hopeless construction of the EMU. My argument has always been that the EMU should be dismantled because it is a creeping danger to democracy.

If the brilliant Mr. Draghi were managing a real central bank, he would simply carry out old fashioned open market operations – with an eight hundred year history – and keep buying assets on whatever scale is needed to meet the ECB's 2% inflation target. Instead, he oversees a zoo. Forced by abominable circumstances, Mr. Draghi must blow smoke in our eyes."

European Central Bank President Mario Draghi. Photo source: Action Press

- Front Page Headline, GoldMoney – "Why It Matters If the Gold Market Is Manipulated. Researcher Alasdair Macleod writes: 'The fact that people don't use gold as money in their daily business does not invalidate its status. Rather, gold is subject to Gresham's law which famously states that bad money drives out the good. We would rather pay for items with a government-issued paper currency while holding on to gold for a rainy day. As money, gold is on the other side of all asset prices. In other words, stocks, bonds and other property prices can be expected to rise measured in gold when the gold price declines and vice-versa. This relationship is often muddled by other factors, the most obvious one being changing levels of confidence in paper currencies against which gold is normally priced. However, with bond yields today at record lows and equities at record highs, this relationship is fairly evident.

Another way to describe this relationship is in terms of risk. Banks which dominate asset markets become complacent about risk because they are greedy for profit. This leads to banks competing with one another until they eventually ignore risk completely. Obviously, it happened with the American banking crisis in 2008 until house prices suddenly collapsed, threatening to take down the entire financial system. As is commonplace with all financial bubbles, everyone ignored risk and history provides many other examples. Therefore, gold is unlike other assets because a rising gold price reflects an increasing perception of general financial risk, inviting downward pressure on other financial asset prices. So, while the big banks are making money easily by ignoring the risks in equity and bond markets, they don't want the party spoiled by a warning sign from a rising gold price.

This is a long way from proving that the gold market is being manipulated. However, the big banks, plus central banks which are obviously keen to maintain financial confidence, possess both the motive and the means. So, why does it matter if the price of gold is rigged? A freely-determined gold price is central to ensuring that reality – and not financial bubbles – guides us in our financial and economic activities. Artificially suppressing the gold price is rather like turning off the fire alarm because you are unable to cope with the noise level."

- Front Page Headline, The Economist – "The Criminalization of American Business. In its most recent issue, the London-based Economist magazine editorializes: 'Companies must be punished when they do wrong, however, the American legal system has become an extortion racket. The formula is simple enough: find a large company that may have done something wrong; threaten its managers with commercial ruin; preferably with criminal charges; force them to use their shareholders' money to pay an enormous fine in a private settlement, in order to drop the charges. The amounts are mind-boggling. This year to date, Bank of America, JP Morgan Chase, Citigroup, Goldman Sachs and other banks have been disgorged of nearly $50 billion (U.S.) for misleading investors in mortgage-backed securities issues. BNP Paribas is paying $9 billion (U.S.) over breaches of American sanctions against Sudan and Iran. Credit Suisse, UBS, Barclays and others have settled for additional billions.
  Financial firms rarely escape penalties if indicted on criminal charges. Few want to go the way of Drexel Burnham Lambert or E.F. Hutton. For their managers, the threat of personal charges is career-ending ruin. Not surprisingly, it is easier to empty their shareholders' wallets." See also, Economic Winter, Malfeasance in the Financial Services Industry – July 21, 2014.

CLOSING LEVELS FOR FRIDAY, SEPTEMBER 5TH.		WEEKLY CHANGE
Dow Jones Industrial Average	17,137.36	+ 38.91 points
Spot Gold Bullion	$1,267.30 (U.S.)	– $20.10 per troy oz.
Spot Silver	$19.22 (U.S.)	– $0.29 per troy oz.
S&P / TSX Composite	15,569.92	– 55.81 points
10 – Year U.S. Treasury Yield	2.46%	+ 12 basis points
Canadian Dollar	91.90 cents (U.S.)	– 0.07 cent
U.S. Dollar Index Future	83.828	+ 1.034 cents
WTI Crude Oil Futures	$93.29 (U.S.)	– $2.67 per barrel
DJIA / Gold Ratio	13.52	+ 0.24 point
Gold / Silver Ratio	65.94	– 0.05 point

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