Monday September 15th, 2014

LONGWAVE group

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

Monday, September 15th

The New York Federal Reserve reports its Empire State manufacturing index rose to a reading of 27.5 in September – its highest level in 5 years – up from a level of 14.69 in August. The new orders sub-index rose to a reading of 16.9 from a level of 14.1 in

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August, while the component for prices received increased to a reading of 17.4, the highest level since March 2012. The Empire State manufacturing survey covers all of New York State, southern Connecticut and northern New Jersey.

- Eurostat reports euro zone industrial output rose by 1% in July and by 2.2% on a year-over-year basis, driven mainly by a 2.6% increase in the production of capital goods and by a 1.2% growth in the production of non-durable consumer goods. Martin van Vliet, an economist at ING Groep in Amsterdam, noted: "Despite the July report, euro zone industrial production remains more than 10% below its pre-financial crisis peak and the recent weakening in the industrial surveys indicates that manufacturers are finding business more challenging. Naturally, this is not surprising, given the tensions and sanctions between Russia and the West over the crisis in Ukraine and lower demand from some emerging market economies."

- Front Page Headline, Globe and Mail- "OECD Slashes GDP Growth Forecasts. Updating its economic growth forecasts for major developed countries, the Paris-based Organization for Economic Cooperation and Development projected GDP growth in the euro zone of only 0.8% this year and rising only slightly to 1.1% in 2015. In comparison, the OECD foresees the U.S. GDP growing by 2.1% this year and accelerating to 3.1% next year. The OECD slashed France's GDP growth rate by half a percentage point to 0.4% this year and it also cut Brazil by 1.5% to 0.3%. In a statement accompanying its forecast revisions, the OECD warned: 'Given the low GDP growth outlook, the risk could be further sapped if the inflation rate remains near zero – or even turns negative – the OECD recommends more monetary support for the euro area. While recent actions by the European Central Bank (ECB) are welcome, further measures, including quantitative easing (QE), are warranted."

- Front Page Headline, Daily Telegraph U.K. – "The OECD Drastically Reduces Its GDP Growth Forecast for Italy. International Business Editor Ambrose Evans Pritchard writes: The Italian economy will contract by 0.4% this year and it will remain stuck in the doldrums next year with GDP growth of just 0.1%. If so, Italy's public debt will spiral to dangerous levels next year, ever further beyond the point of no return for a country without its own sovereign currency and central bank. Antonio Guglielmi, a global strategist for Mediobanca, reacted: 'This is catastrophic for the finances of the country. We're heading for a debt to GDP ratio of 145% in 2015. Who knows the maximum number that the bond market will tolerate? The number is already scary, but for the time being Draghi's poker game is proving successful and there is now the scent of QE in the air, to keep the game going for a bit longer … If Draghi ends up doing almost nothing – and there is a lot of skepticism about the ECB's plans – Italy is dead.'

It has been an abominable few days for the Italian economy. ISTAT reported today that Italy's industrial output declined by 1% in July from June and by 1.8% from a year ago. It's down by 20% since 2008. Exports from the various regions fell by 2.5% in the 2nd. quarter. The figures for the southern area were nothing short of catastrophic: Sicilia (– 11.1%), Sardegna (– 11.2%)

and Basilicata (– 24.6%). The OECD report elaborated: 'The economic recovery in the euro area has remained disappointing, notably in the largest countries: Germany, France and Italy. Confidence is weakening again and the anemic state of demand is reflected in the decline of the inflation rate, which is near zero in the euro zone as a whole and negative in several countries.' Italy's debt reached 135.6% of GDP in the 1st. quarter, galloping upwards at a rate of 5% of GDP each year. This is happening – despite or because of – a series of austerity packages and even though the country is operating with a large primary budget surplus of 2% - 3% of GDP. Plans to stabilize the debt have been blown to pieces. Note that the Monti government announced three years ago that the ratio would end 2014 at 115%. That Panglossian estimate is likely to be wrong by 25 percentage points of GDP. That is a staggering error in such a short space of time. Was it just bad luck, or were those crafting policy in denial about the fundamental nature of Italy's EMU-rooted crisis?

Zolt Darvas at the Bruegel think tank in Brussels has stated that Italy's nominal GDP is flat or contracting, meaning that it must sustain an increasing debt load on a static base. This is a classic debt-compound trap. Mr. Darvas elaborated: 'The OECD forecast for Italy's GDP is a negative shock. Everything now depends on growth dynamics and that depends on the ECB. I don't think the ECB is yet doing enough. Markets are mistaken if they think the forthcoming blast of ECB lending will act as a super-stimulus merely because it boosts the ECB's balance sheet (perhaps by one trillion pounds over time). The balance sheet is not a meaningful indicator. It has very few indications for monetary policy. Only purchases of assets will really make a difference.' Exactly so, plus we don't yet know whether that will be just a token gesture – like its earlier purchases of 60 billion of covered bonds – or on a relevant scale. In a speech last week, the ECB's Yves Mersch stated that this would be neither like Anglo-Saxon QE, nor is it intended to be.

Italy's rock star leader Matteo Renzi must have realized by now that his first gamble has failed. Mr. Renzi thought he could ride a wave of economic recovery after snatching power in February, in a remarkably audacious move. However, he has since discovered that Europe is, in fact, not recovering and that his country is trapped, with no way out under the current deflationary/contradictory policies of the EMU regime. If Italy slashes wages and deflates the economy further, in order to regain lost competitiveness within the EMU, the 'denominator effect' will automatically cause the debt ratios to rise. There is no plausible remedy to this situation unless the EMU switches tactics to embrace massive reflation, which in point of fact, the ECB is not about to do."

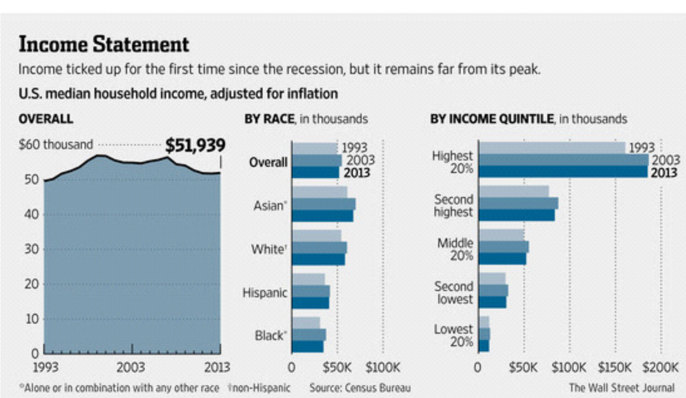
- Front Page Headline, SovereignMan.com – "Respect Old People Day. Today is rather a peculiar public holiday in Japan. However, judging by the official demographics, an increasing proportion of the population should be revered today. One in eight Japanese is age 75 or older. People over age 65 will soon reach 33 million – the largest ever – roughly 26% of the population. The interesting thing about demographic trends is that they're like a huge oil tanker. Once they're on their course, it's very difficult to steer them around in another direction.

These are monumental, generational changes which are extremely difficult and very slow to reverse. By today's trend, Japan's population will dwindle from 127 million to about 100 million by 2050. It's the worst possible demographic nightmare. Couples stopped having several babies decades ago because it was just too darned expensive. Then the big economic collapse arrived in the late 1980s and the domestic economy has been dragging its heels ever since. When prosperity is low, people naturally delay having children. Either they have fewer children, or they don't have any at all. This has enormous long-term implications for the country and its fundamentals. Fewer people of working age means fewer jobs, less productivity, less consumption and less federal tax revenue. Conversely, a bulging group of older people means increased spending for pensions and medical care. In the recently proposed federal budget for the fiscal year 2015, the Japanese government earmarked 31.7 trillion yen for social security, health care and welfare. This is the largest item in the budget, consuming 31.2% of all planned spending and it's only getting bigger. It doesn't help that Japan is essentially bankrupt. The second largest item in the Japanese government's budget is bond interest. While social security, welfare and health spending has increased by 3% from the current budget, debt servicing costs are up by 11% and now amount to 25.8 trillion yen, or an incredible 25% of Japan's budget. So just between pensions and bond interest, the government is expending 57.5 trillion yen. During 2013, the government only collected 50 trillion yen in tax revenue. So, before the government spends a single yen on anything else – anything at all – it is already 7 trillion yen (about $70 billion U.S.) in the hole. The government must borrow the rest. Bear in mind, this is coming at a time when the yield level for the 10-year Japanese bond is 0.5% and even closer to zero on shorter term notes. If the 10-year bond yield rises to just 1%, which is still historically very low, Japan will spend almost all of its tax revenue on just servicing the debt. One can't make this stuff up. It's a screaming indicator that this system can't possibly survive. The United States, Europe and Japan – three of the biggest economies in the world – are all on a similar inevitable trend. They're in debt up to their eyeballs, with absolutely no arithmetic possibility of ever climbing out of the hole unscathed. See also, Economic Winter, It's Still the Debt, Stupid – March 21, 2014.

History is so full of examples of what governments do when their country gets into this position: as reality beckons, they become even more careless and destructive. Japan is just the worst of them all. The question of when it will happen is irrelevant. What difference does it make if Japan collapses tomorrow, or two years from now? This is not a credible and sustainable system which is worth tying up all of one's livelihood and life savings. Nobody is going to send you an advance notice that the banks will remain closed tomorrow and all deposits will be frozen. That's why we always tell investors to buckle up your seatbelt ahead of time. To quote a saying from Shakespeare's The Merry Wives of Windsor: 'Better three hours too soon, than a minute too late."

TUESDAY, SEPTEMBER 16TH

- In its latest survey of American living standards, the U.S. Census Bureau reports the median annual household income – the level at which half are above and half are below – rose by 0.3% in 2013, or a total of $180 (U.S.), to an inflation adjusted $51,939 (U.S.), or about 8% below its level in 2007. Last year, nearly 45.3 million Americans were living below the poverty line of a $23,624 (U.S.) annual income for a family of four. Chris Christopher, an economist at IHS Global Insight, commented: "Many middle-class families were forced into a lower standard of living during the recession and this anemic economic recovery. Sluggish earnings and high poverty rates help explain today's bifurcated consumer spending patterns. Discount stores are doing well and luxury stores are doing great; while the middle tier retailers are having a difficult time gaining traction."



- The Labor Department reports the U.S. producer price Index (PPI) was unchanged in August at a 1.8% annual rate on a seasonally adjusted basis.

- Statistics Canada reports the nation's manufacturing sales reached a record $53.7 billion (CAD) in July, citing gains in 16 of 21 major sectors – representing 56% of the country's manufacturing output – and led by aerospace, primary metals and motor vehicle sales. Krishen Rangasamy, an economist at the National Bank of Canada noted: "Real shipments grew at an annualized pace of 10.5% in the 2nd. quarter – the best since 2011 – and based upon July's good results, it seems that factories are replicating the performance in the 3rd. quarter."

WEDNESDAY, SEPTEMBER 17TH

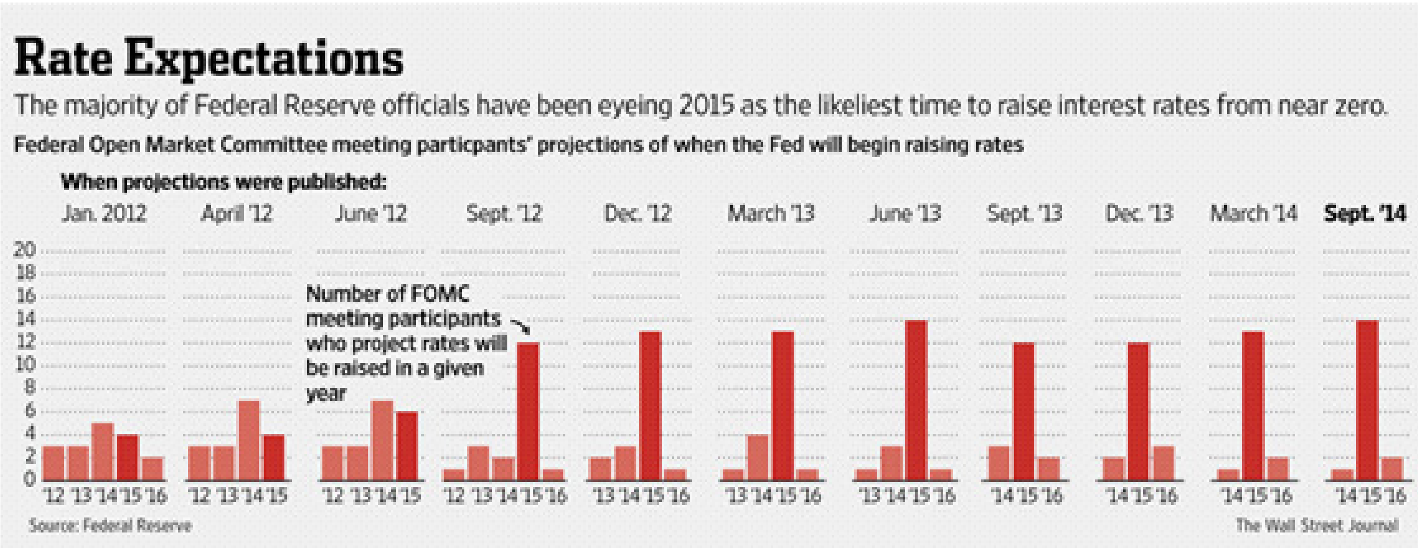
- The Labor Department reports the U.S. consumer price index (CPI) declined by 0.2% in August, the first drop since April 2013. Separately, Eurostat reported the euro zone inflation rate was 0.4% in August on an annual basis.

- The Washington-based National Association of Home Builders /Wells Fargo group reports its U.S. confidence index rose to a reading of 59 in September, following a level of 55 in August. In a statement, NAHB Chairman Kevin Kelly observed: 'Since early summer, home builders in many markets across the nation have been reporting that buyer interest and traffic have improved – a positive sign the housing market is moving in the right direction.'

- Front Page Headline, Wall Street Journal – "FOMC Remains Cautious About Raising Fed Funds Rate. In its regularly scheduled monetary policy meeting, U.S. Federal Reserve Chairwoman Yellen stated:'Since the Federal Open Market Committee meeting in July, domestic economic activity has expanded at a moderate pace … However the (official) unemployment rate is little changed and a range of labor market indicators suggests that there remains significant underutilization of labor resources in the economy.

U.S. Federal Reserve Chairwoman Janet Yellen.
Photo source: WSJ

The FOMC anticipates it will be appropriate to maintain the current target range for the Federal Funds Rate, i.e. 0% to 0.25%, for a considerable length of time after the asset purchase program ends in October.



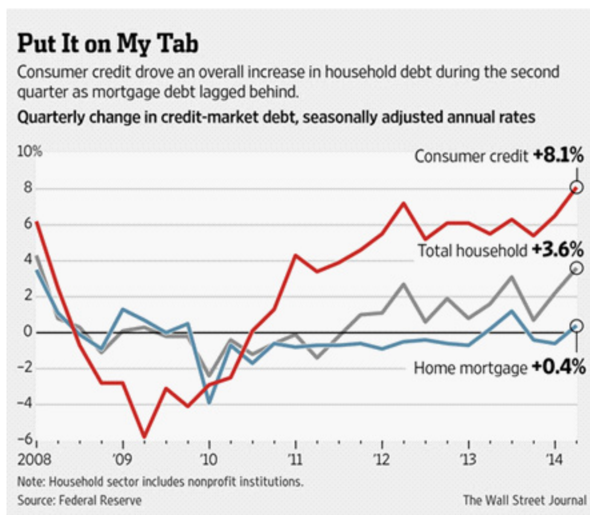
- In a sovereign credit rating update, Moody's Investors Service confirmed America's 'AAA' sovereign credit rating outlook remains stable, citing the size and diversity of the economy and the status of the dollar and Treasury bond market as world benchmarks. Moody's elaborated: "While the near-term outlook of most indicators of economic and fiscal performance are positive, long-term considerations could put pressure on the credit rating. Spending on social programs is projected to pressure budget deficits and the nation's debt to gross domestic product (GDP) ratio. Pressure on the creditworthiness could develop toward the end of the decade if there are no changes in fiscal policies, budget deficits and the national debt burden."

THURSDAY, SEPTEMBER 18TH

- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 36,000 to 280,000 in the week ended September 13th. while continuing claims fell by 63,000 to 2.43 million in the week ended September 6th. – the lowest number since May 2007.

- The Commerce Department reports U.S. housing starts declined by 14.4% in August to a seasonally adjusted annual pace of 956,000 units from an upwardly revised annual rate of 1.12 million units in July.

- Front Page Headline, Wall Street Journal – "U.S. Household Wealth Reaches New Record. The Federal Reserve reports the net worth of American households and non-profit organizations – the value of homes, investments and other assets minus debts and other liabilities – rose by about $1.4 trillion (U.S.) in the 2nd. quarter to $81.5 trillion (U.S.), the highest level on record. Overall, household borrowing rose at an annualized 3.6% pace in the 2nd. quarter – the highest rate since the 1st. quarter of 2008 – led by a sharp increase in consumer credit; including student loans which rose by 8.1%, up from a 6.5% pace in the 1st. quarter.



- Front Page Headline, Washington Post – "DOJ Preparing Criminal Charges Against Wall Street Executives. In a WP interview at New York University Law School, U.S. Attorney General Eric Holder revealed: 'The U.S. Department of Justice has launched criminal fraud investigations of individuals at Wall Street firms, with the hopes of filing formal charges in the coming months. We are making good progress in these cases, which involve conduct which has undermined the integrity of our markets. When it comes to financial fraud, the Justice Department recognizes the inherent value of bringing enforcement actions against individuals, as opposed to simply the companies that employ them. Despite the growing jurisprudence that seeks to equate corporations with people, corporate misconduct must necessarily be committed by flesh-and-blood human beings.' According to unnamed sources familiar with the cases, at least seven banks, including Barclays, Citigroup and JP Morgan Chase disclosed in regulatory filings last year that 'various U.S. government authorities' had requested information about their trading activities." See also, Economic Winter, Malfeasance in the Financial Services Industry, Summation – July 21, 2014.

U.S. Attorney General Eric Holder.
Photo source: Associated Press

FRIDAY, SEPTEMBER 19TH

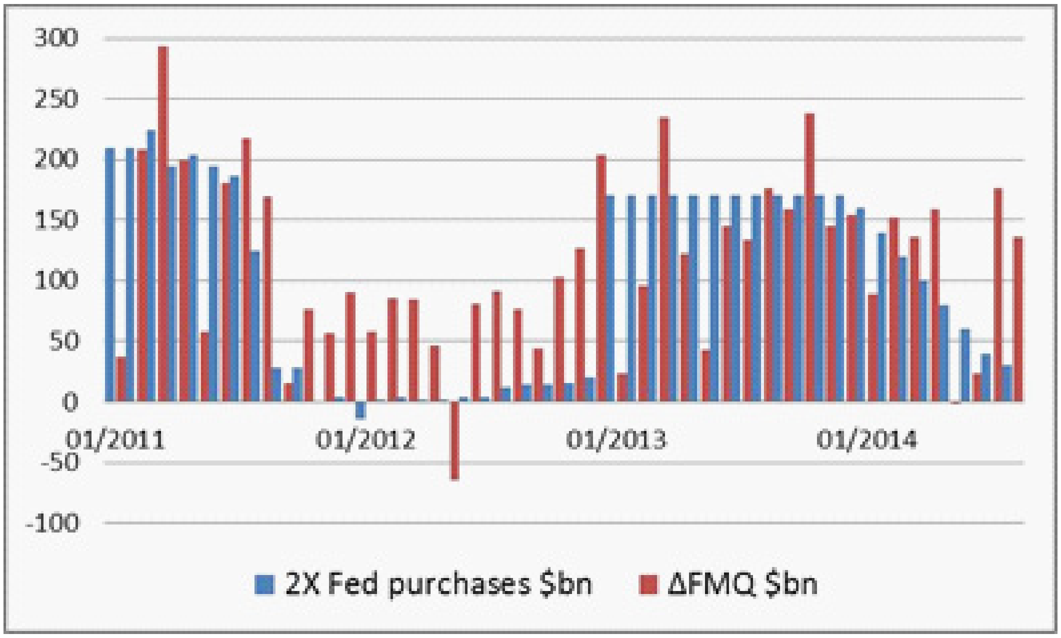
- Front Page Headline, Bloomberg News – "Scotland Votes to Remain in the United Kingdom. In a referendum on independence, by a vote of 55.3% to 44.7% Scotland decided to remain part of the U.K. whilst obtaining a promise of more financial power from Prime Minister David Cameron in London.

A group of Scottish voters emphatically reject independence. Photo source: Getty Images

- The New York-based Conference Board reports its index of U.S. Leading Economic Indicators – a gauge of the domestic outlook for the next three to six months – rose by 0.2% in August, following a 1.1% gain in July.

- Statistics Canada reports the nation's Consumer Price Index (CPI) held steady at an annual rate of 2.1% in August, while the core rate – excluding food and energy – rose to 2.1% from 1.7% in July; its highest level since April 2012. David Madani, an economist at Capital Economics noted: "Overall, with underlying inflationary pressures still fairly subdued and the economic outlook still unpredictable, we doubt this latest inflation report will change the Bank of Canada's neutral outlook for monetary policy."

- Front Page Headline, GoldMoney – "The End of Fed Tapering and U.S. Government Funding. Researcher Alasdair Mcleod writes: Last year, the financial markets behaved nervously on rumours that the Federal Reserve's monetary policy (a.k.a. Quantitative Easing 3) would be tapered. This year, investors have lived with the fact. As it turned out, there has been little or no damage to the financial markets, with bond yields near historic lows and equity markets setting new highs. This contrasts with the closure of QE1 and QE2, which were marked by declines in the S&P 500 Index of 9% and 11.6%, respectively. Presumably, the introduction of the twist strategy, followed by QE3, was at least partly designed to return financial assets to a rising price trend and Federal Open Market Committee (FOMC) tapering has been consistent with this strategy. From a monetary point of view, there is only a loose correlation between the growth of fiat money as measured by the Fiat Money Quantity (FMQ) and monthly bond purchases by the FOMC. The FMQ is unique in that it specifically seeks to measure the quantity of fiat money created on the backing of gold originally given to the commercial banks by our forebears in return for monetary substitutes and deposit guarantees. This gold, in the case of Americans' forebears was then transferred to the Federal Reserve by these commercial banks after the Federal Reserve System was created in 1913. Subsequently, gold has always been acquired by the Fed in return for fiat dollars. Therefore, the FMQ is the sum of cash plus instant access bank accounts and commercial bank assets held at the Fed. The chart below outlines the monthly increases in the Fed's asset purchases and of changes in the FMQ.



The reason I record double the monthly Fed purchases is that they are recorded twice in the FMQ. The chart shows that the creation of fiat money continues without QE. That being the case, QE has less to do with stimulating the economy – which it has failed to do – and is more about funding government deficits. Thanks to the Fed's monetary policies, which have encouraged an increase in demand for U.S. Treasurys, the Federal Government no longer has a problem funding its deficit. Therefore, QE is redundant and has been since QE was first adopted. This does not mean that QE is going to be abandoned forever: its reintroduction will depend upon the relationship between the government's financing needs and the bond market's demand for its debt.

This analysis is confirmed by Japan's current situation. In Tokyo, QE coincides with an economy that is deteriorating by the day. One cannot argue that QE has been good for the Japanese economy. The reality behind 'Abenomics' is that Japan's government is funding a massive deficit at the same time that savers are drawing down capital in order to cover their day-to-day living requirements. In short, the funding gap is being covered by printing money. So now, the collapsing yen, which is the inevitable consequence of monetary inflation, threatens to expose this folly. On a final note, there appears to be complacency in the capital markets about government deficits. At some point, a yield rally will occur in the bond markets, severely disrupting government fund raising. When this occurs and it becomes obvious to everyone that QE does nothing for economic growth, it will be difficult to reintroduce it as a disguised funding mechanism for governments, without undermining confidence in the fixed income market." See also, Economic Winter, Desperate Acts to Retain the Paper Monetary System – September 19, 2014.

CLOSING LEVELS FOR FRIDAY, SEPTEMBER 19TH.		WEEKLY CHANGE
Dow Jones Industrial Average	17,279.74	+ 292.23 points
Spot Gold Bullion	$1,216.60 (U.S.)	– $14.90 per troy oz.
Spot Silver	$17.82 (U.S.)	– $0.82 per troy oz.
S&P / TSX Composite	15,265.35	– 266.03 points
10 – Year U.S. Treasury Yield	2.57%	– 4 basis points
Canadian Dollar	91.35 cents (U.S.)	+ 1.21 cents
U.S. Dollar Index Future	84.796	+ 0.623 cent
WTI Crude Oil Futures	$92.41 (U.S.)	+ $0.14 per barrel
DJIA / Gold Ratio	14.21	+ 0.42 point
Gold / Silver Ratio	65.27	– 0.80 point

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