

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



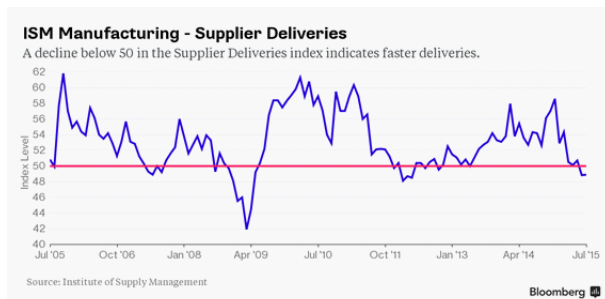
Monday, August 3rd

The Commerce Department reports U.S. construction spending rose by 0.1% in June, following an upwardly revised gain of 1.8% in May, previously reported as an increase of 0.9%; citing construction outlays rose to a seasonally adjusted \$1.06 billion (U.S.).

MONDAY, AUGUST 3RD
B.C. Day - Civic Holiday in Canada

Spending increased by 0.4% for new houses, condos, apartment buildings and other residential properties, while outlays for non-residential and commercial projects were flat.

- The Tempe, Arizona-based Institute for Supply Management (ISM) reports its manufacturing index declined to a reading of 52.7 in July, following a level of 53.5 in June. Readings over 50 indicate more companies are expanding manufacturing activity, while readings below 50 indicate some degree of contraction. While the new orders sub-index edged higher to a reading of 56.5 from a level of 56.0 in June, the employment component declined sharply to a reading of 52.7 from a level of 55.5.

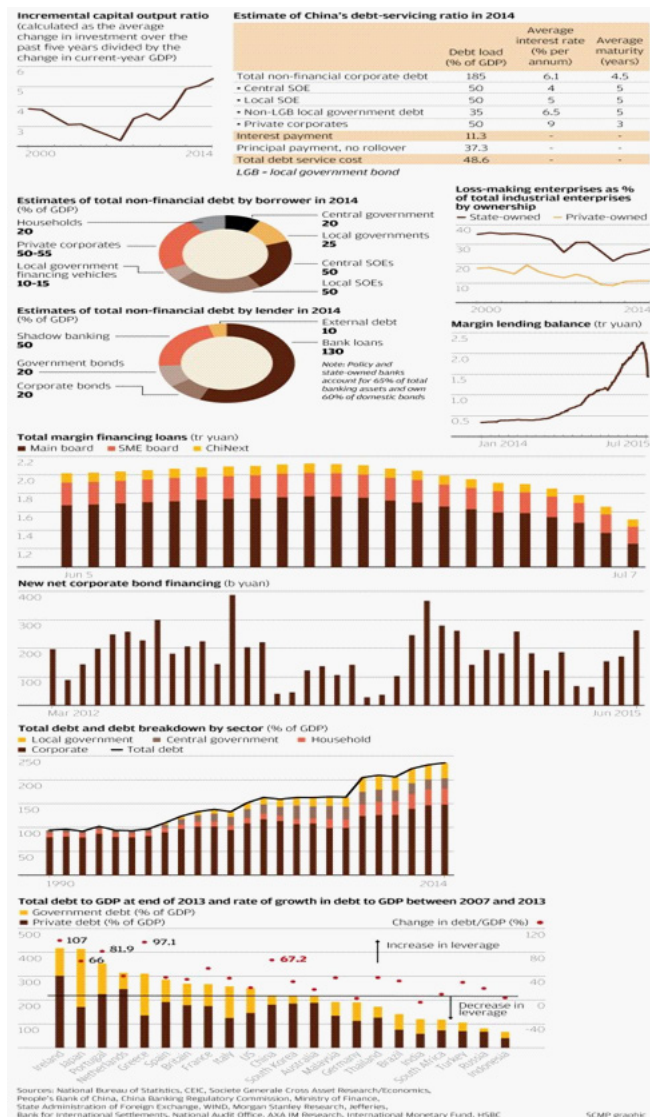


- The Commerce Department reports U.S. personal spending rose by 0.2% in June – the smallest gain since February – following a revised gain of 0.7% in May. Personal income, which includes wages and government aid, increased by 0.4%, following a revised gain of 0.4% in May.

- Front Page Headline, Business Insider – “A \$26 Trillion (U.S.) Debt Problem Is Crushing Competitiveness in China. The nation’s debt mountain is widely estimated to exceed 250% of gross domestic product (GDP) – roughly equivalent to \$26 trillion (U.S.) and which is unlikely to peak before 2018. China’s rate of GDP growth since the beginning of the global financial crisis in 2007 has been exceeded only by the euro zone countries which have required international bailouts to ward off bankruptcy. The mainland corporate sector is among the most indebted in the world and the drag on economic activity is being made worse because most of the debt has been accumulated by state owned enterprises that deliver a declining share of economic growth. The good news is that most of the debt is denominated in yuan, which helps insulate Beijing’s \$3.7 trillion (U.S.) of foreign reserves and almost all the debt has been borrowed by, or is owed to, entities ultimately owned and backed by the government.

However, the overarching bad news is that the cost of servicing the debt and China’s dependence on credit to drive the domestic economy has become so acute that it now requires non-financial businesses to use about 1.6 units of leverage in order to deliver a one unit increase in GDP growth. Paul Markowski, president of New York-based Falconbridge / MES Advisers, told the South China Morning Post (SCMP): ‘True, most of China’s debt is owned by domestic investors and China has a huge foreign exchange reserve cushion, but the debt level affects balance sheets, raises risk profiles and affects the application of economic policies. China’s growth paradigm and the use of liquidity and fiscal policy measures to maintain economic growth in order to prevent unemployment risks, means that China is risking a

sea of credit and balance sheet depletion.’ According to Yao Wei, chief China economist at Societe Generale, digging itself out from under the debt pile could take China a decade and the urgency to do so is increasing; especially as domestic economic growth has slowed further in the first half of this year from the 24-year low it hit in 2014. In a recent research note, Yao wrote: ‘By itself, debt is not necessarily a problem, but if the borrowed funds go to finance investments that generate diminishing returns, then it is. As the GDP growth deceleration and financial market liberalization accelerates, denying the debt problem is becoming an unviable strategy.’



by analysts at Bank of America Merrill Lynch. By this combination of currency, loan growth and real interest rates, mainland monetary conditions are as tight – if not tighter – than they were after the People’s Bank of China announced a combination of reductions to interest rates and bank reserve requirements in response to plunging stock prices in late June.”

- Front Page Headline, Daily Telegraph U.K. – “Former Trader Sentenced to 14 Years for Rigging Libor Rates. Tom Hayes, a 35-year old trader, has been sentenced to 14 years in prison after becoming the first person to be convicted by a British jury of rigging Libor rates, following a trial at London’s Southwark Crown Court. The jury unanimously found Hayes guilty of eight counts of conspiracy to defraud, after a week of deliberations at the end of a two-month trial. The Serious Fraud Office argued that Hayes was at the center of a network of traders at ten firms which conspired to manipulate the Libor (London Interbank Offered Rate) benchmark between 2006 and 2010. Since the scandal was uncovered, at least six banks have paid billions of pounds in fines and several have fired their chief executives.

Mr. Justice Cooke told London’s Southwark Crown Court that the sentence was intended to send a message to the rest of the banking world: ‘You played a leading role in the manipulation of the Libor. You exerted pressure on others, essentially trained those junior to you in the activity and made corrupt payments to brokers for their assistance. The conduct involved here is to be marked out as dishonest and wrong. Accordingly, this is a message to be sent to the world of banking. The reputation of Libor is important to the City as a financial sector and the banking institutions of this City. Probity and honesty are essential, as is trust. The Libor activity, in which you played a leading role, put all of that in jeopardy.’”



Trader Tom Hayes at Southwark Crown Court with his wife Sarah. Photo source: AP

Not the least because of deflation, a force that has possessed an unshakeable grip on the corporate sector since early 2012. Deflation only serves to make debt burdens bigger, which is doubly unhelpful to mainland firms facing the tightest real monetary conditions in at least a decade, according to an index devised

TUESDAY, AUGUST 4TH

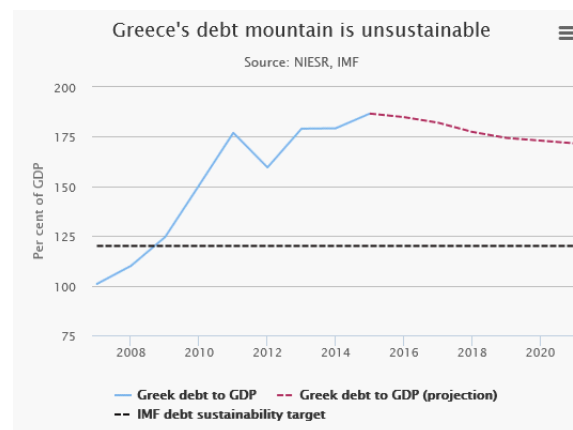
- The Commerce Department reports U.S. factory orders rose by 1.8% in June, following a decline of 1.1% in May; citing a strong demand for aircraft and spawning a 9.3% increase in orders for transportation equipment. There were also increases in orders for machinery, furniture, fabricated metal products, electrical equipment and appliances.
- RBC reports its Canadian Manufacturing Purchasing Managers' Index (PMI) declined to a reading of 50.8 in July from June's six-month high level of 51.3. Paul Ferley, an economist at the Royal Bank of Canada, observed: 'As we progress through the second half of the year, a strengthening U.S. economy and a weaker Canadian dollar should provide a greater boost to exports, as well as business conditions for manufacturers.'
- Front Page Headline, Wall Street Journal – "IMF Outlines Hurdles to China's Bid for Yuan Reserve Currency Status. The International Monetary Fund has published a preliminary assessment of the yuan's fitness for inclusion in the IMF's reserve basket stating: 'Access to China's onshore markets would be important, as well as a free benchmark interest rate.'

Today, there is not enough depth of yuan trading volume in international markets, plus significant gaps in financial data still exist.' In recent weeks, Chinese officials have signaled their intention to press ahead with the liberalization of the country's financial markets and allow foreign investors greater access to Chinese securities, despite a stock market rout and unprecedented government intervention that raised questions about Beijing's commitment to reforms. However, last month the People's Bank of China (PBOC) removed the quotas limiting investments by foreign central banks, sovereign wealth funds and other big financial institutions in the country's \$6.1 trillion (U.S.) bond market. In a statement posted on its website today, the PBOC acknowledged: 'The central bank will continue to carry out market-oriented financial reforms and maintain the yuan's exchange rate stability at a reasonable level.'

- Front Page Headline, Daily Telegraph U.K. – "Greece Needs 100 Billion Euro Debt Relief as Permanent Depression Looms. In a new report, the National Institute of Economic and Social Research (NIESR) laid bare the impact of VAT (value added tax) hikes and strict budget targets which could become self-defeating for Greece. It's report predicts Greece's economy will slump back into recession both this year and next. By the end of 2016, the Greek economy is forecast to be 30% smaller than at its peak in 2007. Jack Meaning, an NIESR research fellow,

warned: 'We don't see Greece getting back to the level it was when it joined the European Monetary Union (EMU) in 2001, let alone anywhere near where it was before this crisis struck. So, this will be a prolonged and severe depression for Greece.'

The NIECR report noted that Greece's creditors would need to write off or restructure 95 billion euros of its 320 billion euro debt mountain, or about 55% of gross domestic product (GDP), in order to reduce the debt stock to about 130% of GDP, from a projection of 187% this year. This would make an International Monetary Fund (IMF) debt target of 120% of GDP by the year 2020 – which the IMF considers to be the maximum sustainable level – at least possible ... Under current projections, Greece's economy is not expected to return to its pre-euro size until the first half of the year 2023.



WEDNESDAY, AUGUST 5TH

- The Tempe, Arizona-based Institute for Supply Management (ISM) reports its U.S. services sector index soared to a reading of 60.3 in July – the highest level in 10 years – from a reading of 56 in June. Both the business activity and new orders components posted readings over 60. A reading above 50 indicates expansion.
- The ADP National Employment Report estimates U.S. private companies hired 185,000 workers in July, while June's payroll gains were downwardly revised to 229,000 from a previously reported 237,000. Mark Zandi, chief economist at Moody's Analytics which jointly compiles the private payroll report, observed: 'While job growth is strong, it has moderated somewhat since the beginning of the year, Nevertheless, even at this slower pace of growth, the labor market is fast approaching full employment.'

The Commerce Department reports the U.S. trade deficit rose by 7.1% to \$43.8 billion (U.S.) in June, from a downwardly revised deficit of \$40.9 billion (U.S.) in May, previously reported as \$41.9 billion (U.S.).

Statistics Canada reports the nation's trade exports surged by 6.3% in June to \$44.6 billion (CAD), the biggest monthly gain since December 2006. Consequently, the country's trade deficit narrowed to \$476 million (CAD) from \$3.37 billion (CAD) in May. In a research note, Diana Petramala, an economist at the Toronto Dominion Bank, stated: 'Canada has likely skidded through the soft patch and with momentum in both consumer spending and exports, is underpinning our view for a rebound in economic growth in the second half of the year.'



Photo source: Associated Press

- Front Page Headline, GoldMoney White Paper – “Gibson’s Paradox Resolved. A new white paper resolving Gibson’s Paradox is posted on GoldMoney’s website, here: We strongly urge all subscribers to read it.

http://www.longwavegroup.com/publications/complementary_commentary/ra_alasdair_macleod.php

While the full ramifications will require further analysis and thought, the immediate implications appear to be:

- It shows that in a free market, commodity prices rise and fall in phase with interest rates and not, as commonly supposed, the other way around.
- It causes us to rethink the relationship between borrowers and savers. In a free market, it is borrowers who set the interest rate.
- It undermines the quantity theory of money, as originally proposed by David Ricardo in 1809 and further refined by Irving Fisher and Milton Friedman.
- It casts into doubt the whole basis of central bank monetary policy.

- It is wholly consistent with Say’s law, reaffirming its validity.

THURSDAY, AUGUST 6TH

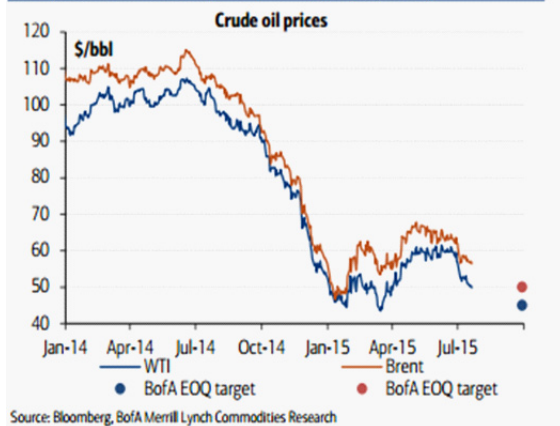
- The Labor Department reports U.S. initial claims for state unemployment benefits increased by 3,000 to a seasonally adjusted 270,000 in the week ended August 1st. while continuing claims declined by 14,000 to 2,255,000 in the week ended July 25th. from an upwardly revised 2,269,000, previously reported as 2,262,000.
- Front Page Headline, Financial Times – “GMO Co-Founder Expects Stock Markets to Be Ripe for a Major Decline in 2016. Jeremy Grantham, co-founder and chief investment strategist at Grantham Mayo van Otterloo – a \$118 billion (U.S.) asset management firm based in Boston – expects stock markets to continue to march higher in the coming year, eventually setting up for a serious decline around the time of the U.S. elections in 2016. Mr. Grantham warns: ‘This could trigger a very different type of financial crisis because many governments have become considerably more indebted ... Moreover, given that central banks were able to create money in order to recapitalize themselves, this could be a crisis which we could weather. If not, then we’re talking like the 1930s, where you have a chain link of government defaults.’”
- Front Page Headline, Daily Telegraph U.K. – “Saudi Arabia May Go Broke Before U.S. Oil Industry Buckles. International Business Editor Ambrose Evans-Pritchard writes: If the oil futures market is correct, Saudi Arabia will be having trouble within two years and be in existential crisis by the end of the decade. The contract price of U.S. crude oil for delivery in December 2020 is currently \$62.05 (U.S.), implying a drastic change in the economic landscape for the Middle East and the petro- rentier states.



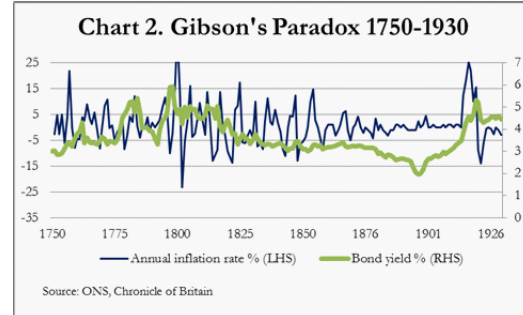
Saudi King Salman bin Abdul Aziz al Saud.
Photo source: AFP /Getty Images

The Saudis took a huge gamble last November when they stopped supporting oil prices and opted instead to flood the market and drive out rivals, boosting their own output to 10.6 million barrels a day into the teeth of the downturn. Bank of America Merrill Lynch analysts believe OPEC is now effectively dissolved. The cartel might as well close down its offices in Vienna in order to save money. If the aim was to choke the U.S. oil industry, the Saudis have misjudged badly, just as they misjudged the growing shale threat at every stage for eight years. In its latest stability report, the Saudi central bank stated: ‘It is becoming apparent that non-OPEC oil producers are not as responsive to low oil prices as had been thought, at least in the short run. The main impact has been to reduce developmental drilling of new oil wells, rather than slowing the flow of oil from existing wells. This requires more patience.’ By causing the oil price to crash, the Saudis and their Gulf allies have certainly killed off prospects for a raft of high-cost ventures in the Russian Arctic, the Gulf of Mexico, the deep waters of the mid-Atlantic and the Canadian oil sands.”

Chart 1: WTI and Brent crude oil prices broke down literally with the start of the third quarter and have fallen by over \$11 and \$8/bbl, respectively



The second chart shows no correlation between interest rates and the annual change in the price level, i.e. the rate of inflation.

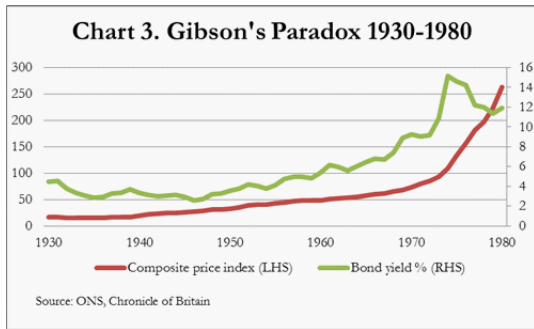


The solution to the puzzle is simple: in free markets, interest rates are set by the demands of investing businesses which at the margin will pay a rate of interest based upon whether their product prices are rising or falling: hence the correlation. The second chart shows that central bank policies, which seek to control prices by setting interest rates, have no theoretical justification behind them. They are the consequence of blindly accepting the quantity theory of money, upon which macroeconomics is based. A mistake made by central bankers is to believe that the price of money is its interest rate, instead of the reciprocal of the price of the products for which it is exchanged. Interest rates are money’s time preference, which in free markets broadly reflects the average time preference of all the individual goods bought with money. The problem with monetarism is that it ignores this temporal aspect of exchange. It is worth bearing in mind that tomorrow’s prices, therefore the purchasing power of money, are wholly subjective, or put another way, cannot be known in advance: if they were, we would be able to buy or sell something today in the certain knowledge of a profit tomorrow, which is obviously not true.

- Front Page Headline, GoldMoney – “Gibson’s Paradox: the Consequences. We now have an explanation for Gibson’s paradox, a puzzle that has defeated mainstream economists from Fisher to Keynes and Friedman. The best way to illustrate the puzzle is via two charts, the first showing empirical evidence that interest rates correlate with the price level.

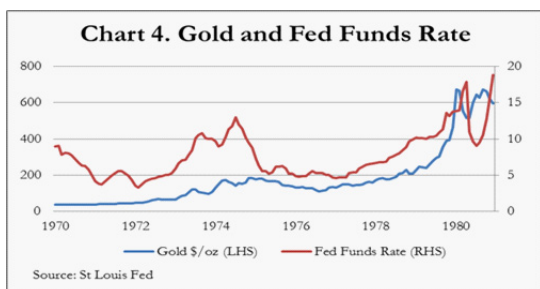


Therefore, it follows that the relative quantities of money are not the key factors in determining price relationships. Far more important are consumer preferences for money against goods, which taken to an extreme can render the purchasing power of a currency to be worthless, irrespective of its quantity. This insight is necessary to put monetary theory into its proper context. Through monetary policy, the Bank of England has overridden free market relationships since the mid-1970s, the Gibson relationship being apparent in the 240 years to then. Chart 3 continues where Chart 1 left off.



The relationship ended when the Bank of England raised its Bank Rate to 17.1% in 1974 in order to stop the hyperinflation of prices. For the first time, the BOE set its administered interest rate higher than the rate would have been in free markets relative to price levels and the U.S. Federal reserve did the same thing five years later. Since then prices have continued to increase, albeit at a declining pace and sterling has lost a further 88% of its purchasing power while the U.S. dollar has lost 76%. Since that time, interest rate management by these central banks has continued to suppress the Gibson relationship, as we should now call it. Monetary policy impairs the market relationship between borrowers and savers. We see this today with zero interest rates suppressing the relationship between savers and investing businesses, creating an economic stasis.

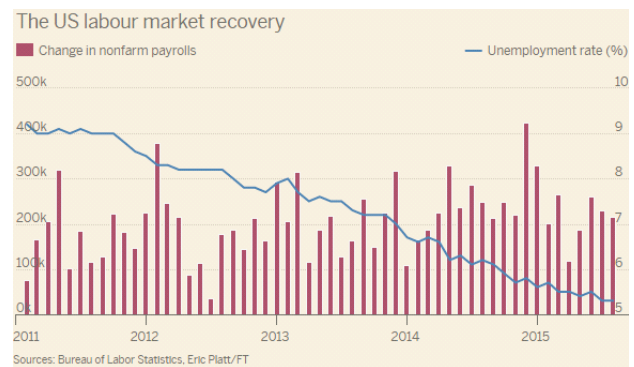
This brings us to a second error exposed by Gibson. The Fed is expected to raise its Federal Funds rate from its zero bound range in a few months' time, in an attempt to return to some sort of normality. According to Gibson, a rising interest rate trend would encourage prices to increase towards and likely through the Fed's 2% inflation rate target. This is neither how the financial traders see it, nor does the Fed. They expect the exact opposite, believing that rising interest rates are bad for demand and commodity prices, which is why the decision has been deferred for so long. The evidence tells us this view is mistaken and that rising interest rates will be accompanied by increasing commodity prices. For example, between 1970 and 1980, the price of gold rose from \$36 (U.S.) per troy ounce to \$800 (U.S.) per troy ounce, while the Federal Funds rate rose from 9% to 17% as seen in Chart 4.



This is a slightly different point, but it graphically illustrates the mistake of thinking the price of anything can be suppressed via higher interest rates.

FRIDAY, AUGUST 7TH

- The Federal Reserve reports U.S. consumer credit expanded by 7.3% in June to a seasonally adjusted annual pace of \$20.7 billion (U.S.), the third monthly increase above 7% in the last four months. Meanwhile, both credit card debt and non-revolving debt – mainly car loans and student loans – also rose at a rate of 7.3% in June.
- The Congressional Budget Office (CBO) reports the U.S. federal government posted a deficit of \$149 billion (U.S.) in July, \$55 million (U.S.) higher than the deficit recorded in July 2014. For the 2015 fiscal year to the end of July, the federal deficit totaled \$463 billion (U.S.), \$2 billion (U.S.) higher than in the first 10 months of fiscal 2014.
- The Labor Department reports U.S. non-farm payrolls increased by 215,000 in July, while the official unemployment rate remained unchanged at 5.3%. While the report disclosed an increase in full-time employment and a decline in part-time jobs, the data also showed that average hourly earnings rose by only 2.1% on a year-over-year basis. Ryan Sweet, an economist at Moody's Analytics in West Chester, Pa. noted: "The trend in job growth remains rock solid. It's more than sufficient to continue to chip away at the slack that's still left in the job market."



- Statistic Canada reports the value of the nation's building permits issued in June rose by 14.8%, led by apartment and condominium construction projects. While the residential and non-residential segments rose by similar percentages, within residential the big distinction was seen in multi-family dwellings, where the value of permits soared by 36.9% from May's level.

- Statistics Canada reports the Canadian economy added a modest 6,600 new jobs in July, while the official unemployment rate remained unchanged at 6.8%, but most of the new jobs created were in part-time work and among the self-employed. Randall Bartlett, an economist at the Toronto-Dominion Bank, commented: "Thirteen of 20 major sectors of the Canadian economy actually contracted in the latest gross domestic product (GDP) report, so that neither points to health in the economy, nor does it suggest the concentration of weakness is in one specific sector."
- The German economics ministry reports the country's industrial production – adjusted for calendar effects and seasonal swings – declined by 1.4% in June. Meanwhile, export orders for Germany's manufacturing industry (adjusted for seasonal swings and inflation) surged by 2% in June, bringing the volume of total orders back to levels last seen in April 2008. The ministry observed: "The trend in manufacturing orders is clearly pointing upwards indicating an ongoing, albeit modest, growth in German output."

CLOSING LEVELS FOR FRIDAY AUGUST 7TH.		WEEKLY CHANGE
Dow Jones Industrial Average	17,373.38	– 316.48 points
Spot Gold Bullion	\$1,094.10 (U.S.)	– \$1.00 per troy oz.
Spot Silver	\$14.78 (U.S.)	+ \$0.06 per troy oz.
S&P / TSX Composite	14,302.70	– 165.74 points
10 – Year U.S. Treasury Yield	2.16%	– 2 basis points
10 – Year Gov't. Canada Yield	1.42%	– 1 basis point
10 – Year Sovereign Yield Spread	74 basis points	– 1 basis point
Canadian Dollar	76.14 cents (U.S.)	– 0.31 cent
U.S. Dollar Index Future	97.558	+ 0.366 cent
WTI Crude Oil Futures	\$43.87 (U.S.)	– \$3.25 per barrel
DJIA / Gold Ratio	15.879	– 0.275 point
Gold / Silver Ratio	74.026	– 0.374 point

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