Monday July 20th, 2015

LONGWAVE group

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

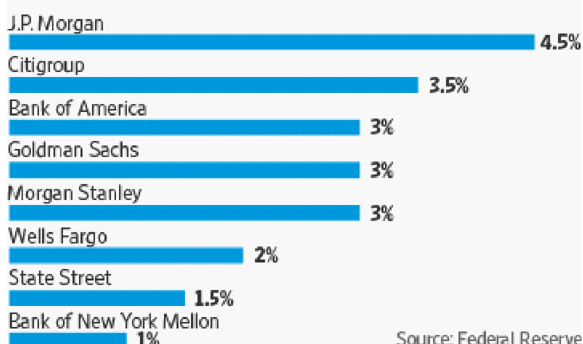
Monday, July 20th

Front Page Headline, MarketWatch News – "S&P Downgrades Puerto Rico's Credit Rating. Citing a default on an outstanding bond issue due for an interest payment on August 1st. as 'a virtual certainty,'

MONDAY, JULY 20TH

Standard & Poor's has downgraded the Commonwealth of Puerto Rico's credit rating to 'CC' from 'CCC' with a negative credit watch outlook. According to S&P: "Puerto Rico's legislature has not allotted for debt service payments in its budget for fiscal 2016 and has recently asked its creditors to join in a discussion concerning the restructuring of its outstanding debt."

- Front Page Headline, Globe and Mail – "Federal Reserve Imposes Capital Surcharges on Eight Largest U.S. Banks. Together, the American banks – which includes Citigroup, Bank of America and JP Morgan Chase – are being directed to shore up their capital bases by $200 billion (U.S.) 'as a cushion against unexpected losses and reduce the likelihood of future taxpayer bailouts. The additional capital requirements will be phased in from 2016 through 2018 and will take full effect on January 1, 2019.'



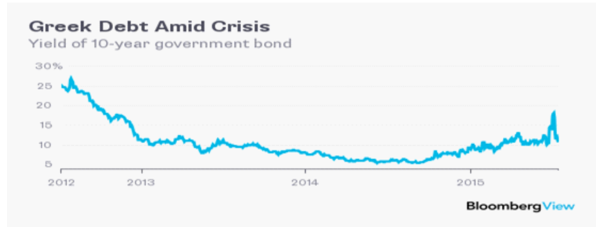
- Statistics Canada reports the nation's wholesale sales declined by 1% to $54.5 billion (CAD) in May, as four subsectors, led by the motor vehicle and parts subsector, moved lower. Sales were down in six provinces with Ontario and Alberta contributing most to the decline.

- Front Page Headline, National Post – "Province of Ontario Is Now the World's Most Indebted Sub-Sovereign Credit. Canada's most populous province – boasting about 13.7 million residents – is forging ahead with an ambitious $130 billion (CAD) infrastructure program over the next decade, which risks further censure of Standard and Poor's (S&P) recent credit rating downgrade to A(high), as well as underperformance for its $307 billion (CAD) of outstanding bond issues. S&P cited: 'Infrastructure spending will lead to a very high 267% debt-to-revenue level over the next two years.' In a press release, Kelsey Ingram, spokeswoman for Ontario's Finance Minister Charles Sousa, confirmed: 'The recent S&P rating downgrade hasn't materially impacted the province's borrowing plans. Ontario intends to issue about $31.1 billion (CAD) of bonds this fiscal year, which includes funds for roads, transit, water infrastructure, schools and hospitals; as announced in its annual budget in April."

TUESDAY, JULY 21ST

- Front Page Headline, MarketWatch News – "S&P Upgrades Greece's Credit Rating to CCC (High). As the Greek government submits legislation for a parliamentary vote tomorrow on the new 86 billion euro ($93.6 billion U.S.) bailout package, Standard & Poor's has upgraded Greece's sovereign credit rat-

ting to CCC (High) from CCC (Low) and raised the outlook to stable from negative. If approved, officials from the lender institutions – the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) – formerly known as the Troika, will be in Athens on Friday to meet with the Greek government.



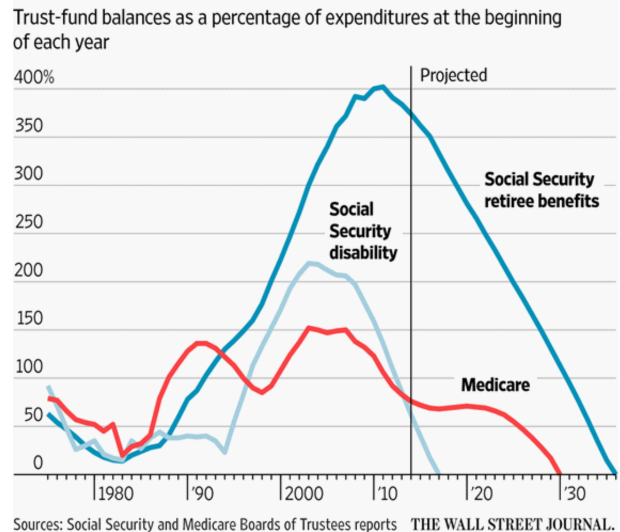
WEDNESDAY, JULY 22ND

- The National Association of Realtors (NAR) reports U.S. existing home sales rose by 3.2% in June to an annualized rate of 5.49 million units; the highest level since February 2007. The median price of an existing home rose by 6.5% to $236,400 (U.S.) on a year-over-year basis; the highest on record before adjusting for inflation. Lawrence Yun, NAR chief economist, commented: "The housing market is tighter compared to last year. Home values are rising too quickly, so the market needs more supply in order to bring the price growth pace down, consistent with income growth."

- Canada's Parliamentary Budget Officer (PBO) reports calculations using the Bank of Canada's latest economic forecast reveal that Ottawa is on track to post a deficit of about $1 billion (CAD) for the current fiscal year ending March 31, 2016. Meanwhile, Rob Nicol, director of communications in the Prime Minister's Office, noted: "The PBO is just one voice, while the Finance Department's numbers show that they remain on track for a balanced budget in the current fiscal year."

- Front Page Headline, Wall Street Journal – "Social Security and Medicare Outlook: Improved but Remain Bleak. In an annual report released by the trustees of both programs, it was disclosed that the long-term deficits of the two largest U.S. benefit programs would be slightly lower than forecast last year. However, the report also offered the latest warning that the Social Security disability insurance program will exhaust its reserves in late 2016, which would initiate a 19% reduction in benefit payments. U.S. Secretary of the Treasury Jacob Lew warned: 'This shortfall should be addressed by Congress via the reallocation of the share of payroll taxes that fund the disability insurance trust fund and the much larger retirement benefit reserves. The reallocation would leave both funds depleted by 2034 – one year later than estimated in last year's report – so it is vital that Congress move forward to maintain the integrity of this critical program sooner rather than later." Meanwhile, Republicans in Congress have stated they won't allow any transfer without taking other steps to improve Social Security's finances. Rising eligibility for women and an aging work force have increased the number of disability beneficiaries. About 6% of workers who were eligible claimed those benefits in 2013, up from 4% in 2001.

Charles Blahous, a Republican trustee for the programs, stated: 'The crisis facing the disability insurance program illustrates the dangers of waiting to act in order to address the intermediate solvency of Social Security. This latest report reveals no big surprises. Yet, we have lost another year due to inaction.'

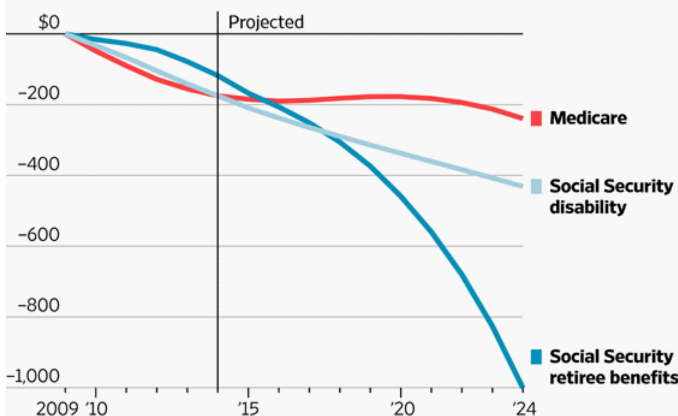


Social Security was designed as a pay-as-you-go program, but since 2010 it has been paying out more in benefit dollars than it collects in tax revenue. While the program enjoyed a $55 billion (U.S.) surplus in 2014, that entirely came from interest it earned on reserves. Excluding interest, the program had a deficit of $74 billion (U.S.) in 2014, versus $76 billion (U.S.) in 2013.

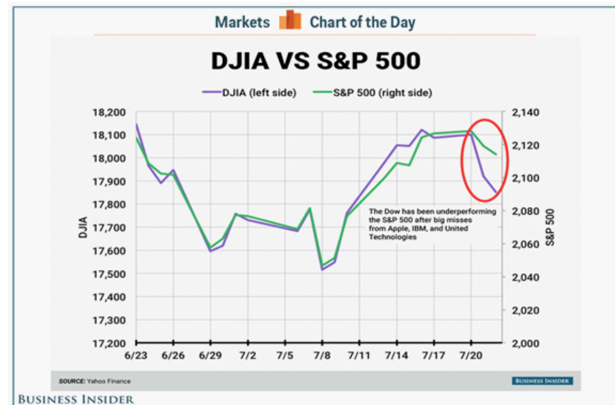
As a share of taxable payroll, the program is projected to experience a deficit of 1.3% this year, the largest ever faced by the program. The trustees project that by 2022, the retirement benefit program will have a deficit even after accounting for interest earnings, leading it to exhaust its reserves by 2035. Once trust funds exhaust their reserves, the government can pay benefits only from revenues which it collects, resulting in either benefit reductions, or delayed payments. Meanwhile, the report stated that Medicare's hospital insurance program, which insured

about 1.6 million more people in 2014 than it did in 2013, will be able to pay full benefits for elderly and disabled patients through 2030. The estimate is unchanged from last year's projection. As recently as 2009, trustees had estimated that the hospital care fund would be depleted by 2017.

Projections for the solvency of Medicare have consistently improved over recent years amid a slower upward trend in health care costs, which Obama administration officials credit partly to the Affordable Care Act. While the projections of Medicare's total costs over the coming 20 years were little changed, the report showed a slightly better long-term forecast. Medicare costs are projected to increase from their current level of 3.5% of economic output, to 6% over the coming 75 years, down from 6.84% in last year's forecast. The hospital insurance program is separate from other Medicare programs, which include outpatient care and prescription drugs. Those are covered by premiums and government spending, not by a trust fund. Today's report stated that Social Security beneficiaries aren't expected to see a cost-of-living increase next year because the inflation rate has been low. That would trigger a provision restricting premium increases for about 70% of Medicare beneficiaries, who would continue to pay their existing monthly premiums of $104.90 (U.S.). However, under current law premiums for the remaining 30% of beneficiaries – including new enrollees, those who don't receive Social Security benefits and enrollees with higher incomes – must be raised substantially to compensate. Under current assumptions, their monthly premiums would be an estimated $159.30 (U.S.). Potential premium changes or cost-of-living adjustments are not finalized until October."

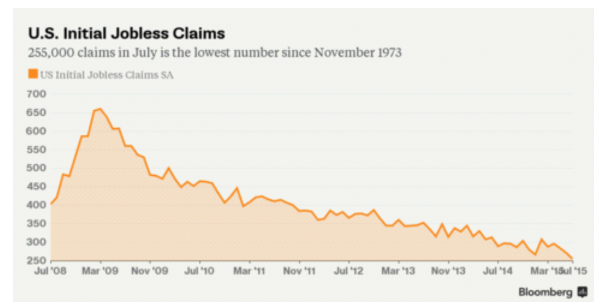


- Front Page Headline, Business Insider – "It's Been a Disappointing Earnings Season for the DJIA. A research note circulated by Hans Mikkelsen at Bank of America Merrill Lynch has revealed that two of the most important U.S. stock indicies, the Dow Jones Industrial Average and the S&P 500, have recently become slightly unglued from each other. Yesterday, Mikkelsen noted: 'U.S. stocks have declined following earnings misses from high profile Dow constituents IBM and United Technologies with the DJIA down 1% on the day, compared with a loss of 0.43% for the S&P 500. We can also add Dow component Apple's 4% drop today after iPhone sales disappointed investors, worsening things for the blue chip index. Today, the Dow closed down 0.38%, while the S&P ended down a more modest 0.24%. Because the Dow consists of just 30 stocks, an outsized move in any component can have a much larger impact in the index than in the S&P, which consists of 500 stocks."



THURSDAY, JULY 23RD

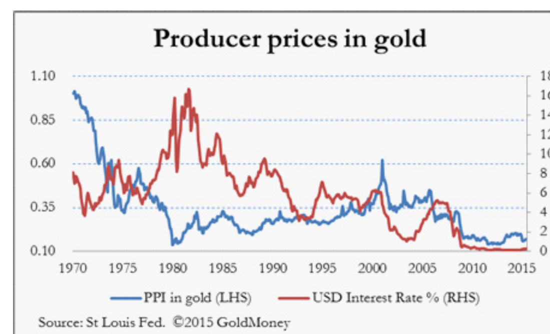
- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 26,000 to 255,000 in the week ended July 18th. – the lowest level since November 1973 – while continuing claims declined by 9,000 to 2.2 million in the week ended July 11th.



- Front Page Headline, GoldMoney – "Gold and Gibson's Paradox. Researcher Alasdair Macleod writes: There is a myth prevalent today that the price of gold always declines when interest rates are rising. The logic is that when interest rates are on the increase, it is more expensive to hold gold, which just marks time not earning anything. So, since markets discount future expectations, the gold price will even decline when an increase in interest rates is expected. With the Fed's Open Market Committee (FOMC) debating the timing of an increase in the Fed Funds Rate, possibly occurring as soon as September, it is no surprise to market commentators that the gold price continues to languor in a bear market. Only the myth is just that: a myth denied by empirical evidence. The chart below dates from a time when the opposite was demonstrably true. From March 1971 to December 1979, the trends in both interest rates and the gold price rose and fell simultaneously. It is worth noting that this occurred over more than one business cycle, so it was not a relationship which was cycle dependent.

Therefore, the myth is satisfactorily debunked. To understand why this relationship between interest rates and gold is not as simple as commonly believed, we must take the argument further to include commodities generally and visit the tricky subject of Gibson's Paradox. This paradox is purely based upon long-term empirical evidence, when gold was transaction money, covering the two centuries between 1730 and 1930.

It observes that the level of wholesale prices and interest rates are positively correlated. It is not the price relationship that is consistent with the quantity theory of money, which presupposes that interest rates correlate to the rate of price inflation instead of the price level itself. This may be a reason why monetarists mistakenly argue, as we also discovered in the 1970s, that central banks can manage the rate of inflation through monetary policy. Today, the common view in markets about the relationship between interest rates and price inflation is wholly at odds with the longer term evidence of Gibson's Paradox and accords with the more fashionable quantity theory instead. Gibson and his paradox are generally forgotten today and those who centrally plan our monetary policy, together with the markets, appear unaware of the challenge it poses to their monetarist preconceptions. None other than Keynes described Gibson's Paradox in 1930 as 'one of the most completely established empirical facts in the whole field of quantitative economics', and Irving Fisher also wrote in 1930that 'no problem in economics has been more hotly debated.' In 1976, even Milton Friedman agreed that 'the Gibson Paradox remains an empirical phenomenon without a theoretical explanation.' Resolving this paradox can be left to another time; instead we shall consider the implications by looking at price relationships between wholesale prices and interest rates in a post-gold world. The chart below is of producer prices measured in gold and compared with one-year U.S. Treasury yields.



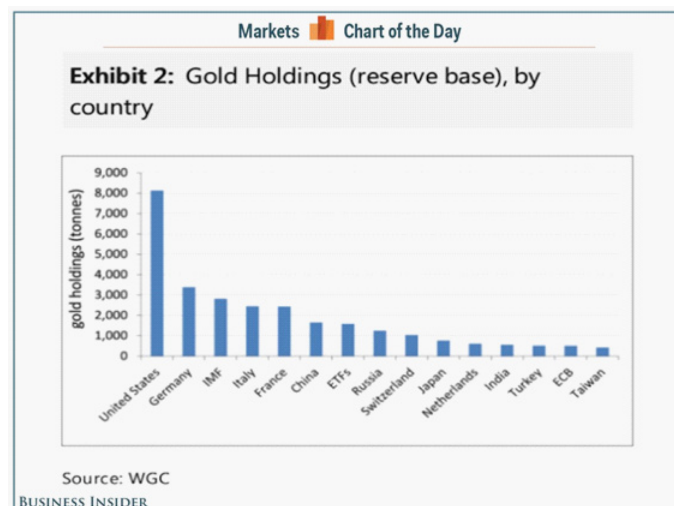
I have taken the St. Louis Fed's 'Producer Price Index by Commodity for Crude Materials for Further Processing' to more closely reflect commodity price trends, as well as reduce the additional considerations of changes in processing margins over time. The one-year Treasury yield is preferred to the original evidence of Gibson's Paradox, which used the yield on undated British Government Consols as being the only continual information on yields available, because we need to more firmly link the evidence to modern monetary policies. Looking at the chart, it is hardly surprising that Gibson's Paradox was quashed from the time of the Nixon shock in 1971, when the U.S. unlocked a huge increase in the gold price by ending the Bretton Woods Agreement. Instead, the gold price assumed a life of its own, driving down wholesale prices measured in gold for the next nine years. The increase in the index from 1980 to 2000 reflected gold's subsequent bear market when gold declined from $800 (U.S.) per troy oz. to $250 (U.S.) per troy oz., but the influence of Gibson's Paradox appears to have returned thereafter.

While this conclusion might be considered suspect, the chart tells us that not only are producer prices at their lowest for 35 years when measured in sound money, but also, the price level coincides with zero interest rates. In theory, it accords precisely

with Gibson's Paradox. So, where do we go from here? There is only one way for interest rates to go from the zero range, it being only a matter of time, which according to the Fed is now running out. Commodity prices in their role as raw materials therefore, seem set to increase with interest rates, if the Paradox is still valid. Furthermore, the evidence from this analysis suggests that wholesale prices are suppressed even more than the price of gold. This being the case, when the interest rate cycle turns, the potential for higher raw material prices measured in U.S. dollars could be truly spectacular; even more so in the event the gold price increases at the same time, which seems likely in the event that financial markets become destabilized by higher interest rates. At this point, it is worth repeating that the economic consensus, which adheres to the quantity theory of money and has been comforted by the apparent absence of consumer price inflation in the wake of the post-Lehman monetary expansion, takes a diametrically opposite view to that posed by the Paradox.

The prospect of a turn in the interest rate cycle is expected to drive the U.S. dollar's exchange rate higher still, weakening commodity prices and the price of gold even further. In the language of the dealers, everyone is on the same side of the trade, meaning the U.S. dollar is technically overbought and commodities are oversold. Gibson's Paradox says the result will be otherwise and it could be central to linking the cyclical relationship between interest rates, securities markets and commodity prices. It becomes much easier to see how these relationships tie together. Rising interest rates would almost certainly be accompanied by a potentially large decline in bond and stock prices, as speculative positions are unwound, the former even undermining bank solvency ratios. The flight of speculative capital from falling markets must go somewhere, particularly if cash balances held in the banks are at a growing risk from systemic default. The Paradox tells us that these are the conditions for commodities to become the safe haven of choice for the highest levels of speculative money ever recorded since fiat currencies dispensed with their golden anchor. Ergo, Gibson's paradox probably still holds.

- Front Page Headline, Business Insider – "These Countries Are Holding Mountains of Gold. Last May, the World Gold Council issued its initial quarterly report on gold demand for 2015 which revealed that demand had dropped by 11 metric tonnes, or by 1%, on a year-over-year basis. Interestingly, China revealed that it was holding far less gold in its central bank reserves than most everyone previously thought and a huge amount of gold was dumped on the market earlier this week during a two minute window. According to the World Gold Council report: 'Global gold demand declined by 1% to 1,079.3 metric tonnes in a generally quiet 1st. quarter. Gold faced local challenges. Headwinds included a global economic slowdown, rallying equity prices in China and near record local prices in Turkey.' So, with the 1st. quarter drop in gold demand the Morgan Stanley chart below, which uses World Gold Council's data, shows which countries are still hoarding the biggest piles of gold."



FRIDAY, JULY 24TH

- Markit Economics reports its composite purchasing managers' index (PMI) for the euro zone – based upon surveys of thousands of companies and deemed a good guide to gross domestic product (GDP) growth – declined to a reading of 53.7 in July, following a level of 54.2 in June. Jennifer McKeown, an analyst at Capital Economics, noted: "While the latest PMI data suggest that the Greek crisis has not derailed the euro zone economic recovery altogether, GDP growth seems to be slowing as the boosts from earlier declines in oil prices and the euro exchange rate fade."

- The Caixin /Markit group reports its purchasing managers' index for China's manufacturing sector fell to a reading of 48.2 in July, the lowest level since April 2015 and the fifth consecutive month for a reading under 50. Helen Lau at Argonaut Securities in Hong Kong observed: "While the PMI reading shows there's no signs of recovery in small and mid-sized businesses, I think it's also related to weak domestic demand during the summer season."

- The Commerce Department reports U.S. new home sales declined by 6.8% in June to an annualized pace of 482,000 units; the weakest level since last November. Ward McCarthy, an economist at Jeffries LLC in New York, commented: "While

there's no question that the housing market moved into high gear in the 2nd. quarter, the June report might be a dose of reality that the acceleration trend was not as sharp as it had looked. However, the outlook for the housing market still remains positive, thanks to more jobs, rising household formations and good affordability levels."

CLOSING LEVELS FOR FRIDAY, JULY 24TH.		WEEKLY CHANGE
Dow Jones Industrial Average	17,568.53	– 517.92 points
Spot Gold Bullion	$1,085.50 (U.S.)	– $46.40 per troy oz.
Spot Silver	$14.71 (U.S.)	– $0.10 per troy oz.
S&P / TSX Composite	14,186.24	– 456.60 points
10 –Year U.S. Treasury Yield	2.26%	– 9 basis points
10 –Year Gov't. Canada Yield	1.48%	– 8 basis points
10 – Year Sovereign Yield Spread	78 basis points	– 1 basis point
Canadian Dollar	76.72 cents (U.S.)	– 0.28 cent
U.S. Dollar Index Future	97.199	– 0.757 cent
WTI Crude Oil Futures	$48.14 (U.S.)	– $2.75 per barrel
DJIA / Gold Ratio	16.185	+ 0.206 point
Gold / Silver Ratio	73.793	– 2.635 points

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