Monday June 22nd, 2015

LONGWAVE group

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

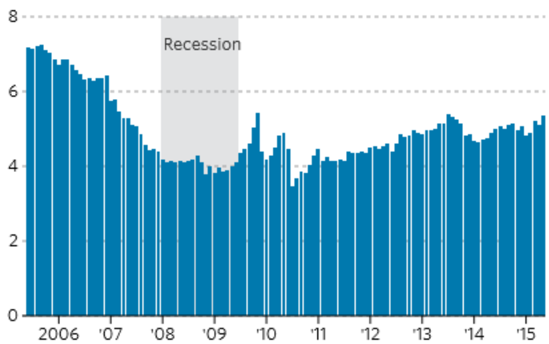
Monday, June 22nd

The National Association of Realtors (NAR) reports U.S. existing home sales rose by 5.1% in May to a seasonally adjusted annual pace of 5.35 million units, the highest level since November 2009; citing a high

MONDAY, JUNE 22ND

number of first-time buyers, continuing reasonable mortgage rates and a bigger inventory of homes listed for sale.

U.S. Existing Home Sales
Homes sold over the past 10 years – in millions



Source: Wall Street Journal

- The Commerce Department reports U.S. new home sales rose by 2.2% in May to an annualized pace of 546,000 units; the highest level in seven years. Today's report cited the median sales price declined slightly by 1% in May on a year-over-year basis.

- Markit Economics reports its composite index of German services and manufacturing rose to a reading of 54 in June from a level of 52.6 in May. Oliver Kolodseike, an economist at Markit, commented: "Today's data paint a mixed picture of the health of Germany's private sector economy. While companies reported that output rose at a stronger rate than in May, the latest increases in new business and employment were only slight and suggest that economic growth may slow down again in coming months."

- HSBC Holdings PLC reports its China Manufacturing Purchasing Manager's Index (PMI) – a nationwide gauge of manufacturing activity – rose to a preliminary reading of 49.6 in June from a final reading of 49.2 in May; but remains below the 50 level which separates expansion from contraction. Annabel Fiddes, an economist at Markit Economics, observed: "The June PMI data revealed while purchasing activity showed signs of improvement, manufacturers continued to reduce staff. This suggests that companies have relatively muted economic growth expectations, as demand conditions both domestic and abroad remain relatively subdued."

TUESDAY, JUNE 23RD

- The Commerce Department reports U.S. durable goods (products expected to last for at least three years) orders declined by a seasonally adjusted 1.8% in May, citing lower demand for commercial aircraft. Orders for core capital goods – a proxy for business investment – rose by 0.4%, but generally remained weak. For the first five months of 2015, business investment was 2.6% lower compared with the same period in 2014.

Workers in a clothing factory in Huabei.
Photo source: AFP/Getty Images

- Front Page Headline, Daily Telegraph U.K. – "A Greek Capitulation: Has P.M. Tsipras Finally Crossed Syriza's Red Lines? Columnist Mehreen Khan reports: The Greeks are back in Brussels. With less than a week left before Greece's bailout program officially expires, the country's Leftist Syriza government seems to have finally tabled a list of proposals which may be acceptable to its creditors. According to leaked documents making the rounds in Brussels last night, the plan presented by Athens constituted an absolute and complete blueprint …European Council President Donald Tusk described the 11-page document as 'the first real proposals in many weeks.'

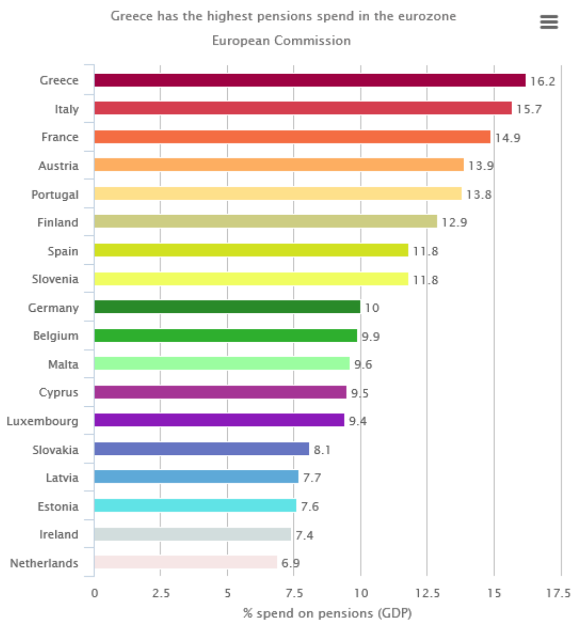
Greek Prime Minister Alexis Tsipras
Photo source: Daily Telegraph U.K.

In a letter forwarded to European Commission President Jean-Claude Juncker, the Greeks outlined their measures – spending cuts and tax hikes – as adding up to about 1.5% of gross domestic product (GDP) in 2015 and 2.5% in 2016. European Finance Ministers will reconvene on Wednesday to lay the groundwork for EU leaders to discuss the plans at a Council summit on Thursday. However, with Syriza MPs already voicing doubts that the agreement can be supported by the party's central committee, the prospect of a domestic revolt could either force more delay, or additional revisions.

In total, the Greek plans amount to about 7.9 billion euros in fiscal measures. Of that, 7.3 billion euros is in the form of tax increases and changes to the social security contributions. One of the most controversial areas of taxation has been the Value Added Tax (VAT). Greece's creditors want the country to implement a simplified two-tier tax structure, rather than the three-level system currently in use. The biggest concession seems to be on the series of VAT exemptions, such as those imposed on food services, e.g. restaurants. These are now set to soar from the middle band of 13% to the highest rate of 23%. However, the leftists have vowed, even in the latest proposals, to keep sacred areas such as medicine and electricity in the lower 6% and 13% bands, respectively. To offset this protection, special VAT privileges for Greece's myriad islands will be abolished. These exemptions, which include the Aegean islands, have long been included in the Greek taxation system and are designed to give support to the poorer areas of the country.

The move represents a U-turn for the Syriza government and has already met with fierce resistance by their nationalist coalition partners who occupy 12 seats in the parliament. In total, the government estimates the VAT overhauls will raise 1.36 billion euros, or 0.76% of GDP, next year. Other tax hikes will focus on corporate profits over 500,000 euros, which will be hit by a special levy of 12%, raising corporate income tax from 26% to 29%.

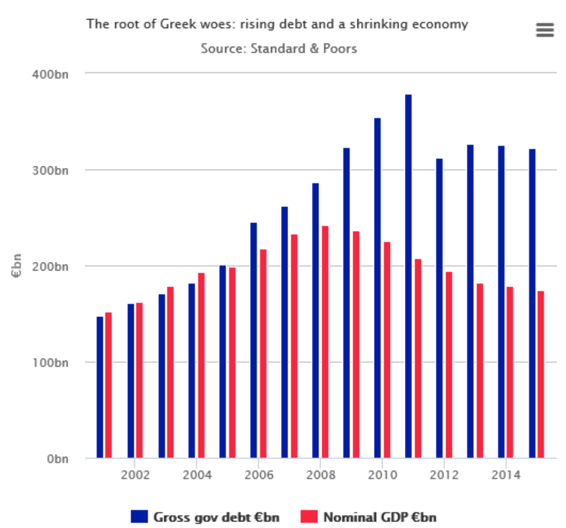
Pension expenditures have emerged as one of the intractable red lines for the Leftist government since it was elected on an anti-austerity platform in late January. The Troika has demanded a pension expenditure reduction of 1% this year, amounting to 1.8 billion euros. The Greeks have long resisted such drastic measures and proposed only a 0.4% cut in pension expenditures last week, amounting to just 73 million euros. Monday's proposals represented a significant increase from the previous plans. Moreover, the government will now abolish early retirement by next year; as well as raise the minimum retirement age gradually to 67 years of age by 2025. Controversial supplementary pensions will also be phased out beginning in 2018. However, Mr. Tsipras has been careful not to reduce the nominal value of individual pensions, still considered a protected area for the poor.



Source: Highcharts

Instead, there will be a radical overhaul in the nature of pension contributions. These are reported to increase by 2% across the board. Pensioners will also see their health care contributions increase by 5%, according to their ability to pay into the system. In total, these measures are expected to generate about 0.4% of gross domestic product in 2015 and 1.1% in 2016; still considerably shy of the 1% that creditors are demanding this year.

- With the Greeks seemingly conceding ground in a number of areas, one issue that remains conspicuous by its absence is the question of further debt relief. Greece's debt mountain is set to increase to 180% of GDP this year.



Source: Highcharts

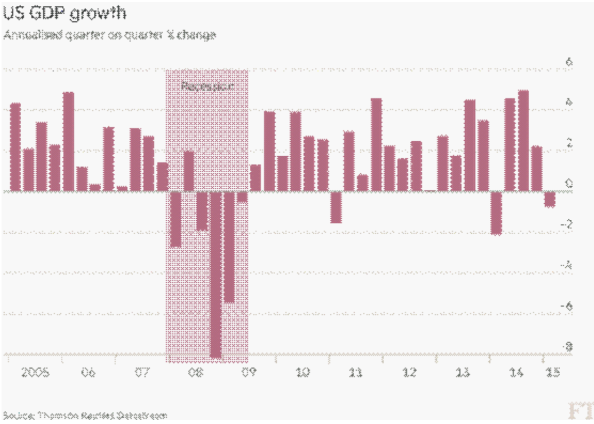
The Idea of a debt swap has been central to Greek demands. Finance Minister Yanis Varoufakis has laid out his plans, which include a measure to restructure the country's debt by redeeming bonds held by the European Central Bank with low interest loans from Europe's rescue fund. However, following Monday's emergency summits, both Jean Claude Juncker and Angela Merkel dismissed the question of debt relief as a matter for another day.

This radio silence is unlikely to go down well in Athens. Mr. Tsipras needs some concession on the country's debt pile in order to effectively sell the agreement to his restless parliamentarians. It has been suggested that creditors will sign off on a temporary extension with the promise of further debt relief after the summer. However, verbal commitments are only likely to go so far as Syriza's radical Left factions harden against EU powers. Analysts at Bank of America Merrill Lynch noted: 'Debt relief and fiscal efforts are intertwined. Looking ahead, the magnitude of the budget surpluses is dependent upon how the debt servicing is reduced. One of the problems with carrying out austerity in the absence of debt relief, is one may end up with too much upfront consolidation.' To hammer home that point, Deutsche Bank economists calculate that the proposals add up to a total fiscal tightening of 3% of GDP, almost equivalent to the belt-tightening suffered by the Greek economy at the height of its woes in 2010.

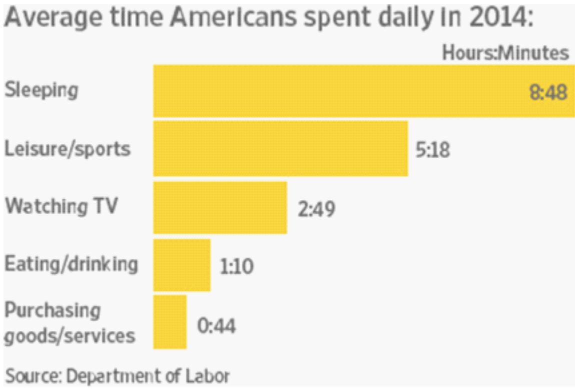
- Technical teams from Greece's creditors will now spend the next few days crunching the numbers to see if the Greek proposals add up to a credible fiscal commitment to hit a proposed 1% primary budget target this year. Crucially, we've yet to hear much from Greece's senior creditor and probably the most awkward member of its creditor bloc, The International Monetary Fund. The IMF's verdict on the path of debt sustainability is likely to be crucial to hopes of an agreement being struck prior to the end of the month. However, even without the IMF's assent, economists have raised plenty of doubts over whether tax hikes are the best remedy for an economy which has already slipped into recession this year. Michael Hewson of CMC Markets observes: 'Even a basic knowledge of economics should tell one that raising taxes when demand is shrinking is like squeezing the juice out of an already barren lemon. Therefore, it seems that a lot of these measures are based upon some very optimistic forward-looking assumptions, which in the real world are unlikely to be met.'

WEDNESDAY, JUNE 24TH

- The Commerce Department reports the U.S. gross domestic product (GDP) declined at a revised annual rate of 0.2% in the 1st. quarter, previously reported as a drop of 0.7%, citing a higher level of consumer spending.



- In its American Time Use Survey for 2014, the Labor Department reports not only were more Americans employed last year, but also, employed Americans spent more time at their jobs; as work days set a daily average of 7 hours and 45 minutes in 2014, up from 7 hours and 35 minutes in 2013.

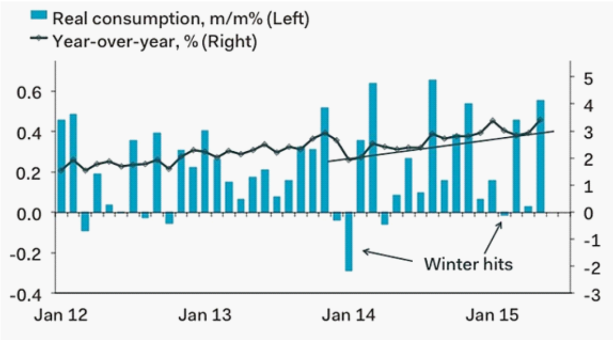


THURSDAY, JUNE 25TH

- The Labor Department reports U.S. initial claims for state unemployment benefits increased by 2,000 to 271,000 in the week ended June 20th. while continuing claims increased by 22,000 to 2.25 million in the week ended June 13th. Russel Price, an economist at Ameriprise financial in Detroit, noted: “Companies are holding onto their employees very tightly and recent claims reports confirm a strong need for labor. Moreover, it implies very positive trends for job growth in the months and quarters ahead.”

- The Commerce Department reports U.S. consumer spending rose by a seasonally adjusted 0.9% in May, led by a 2.2% increase in automobile sales, the biggest gain since August 2009. TD Securities economist Millan Mulraine observed: “The robust rebound in consumer spending provides additional confidence that the economic recovery is continuing to accelerate on the positive momentum of recent months.”

U.S. Consumer Spending



Source: Pantheon Macroeconomics

- Front Page Headline, GoldMoney – “Managing Trade Deficits. Researcher Alasdair Macleod writes: Currency devaluation is seen by nearly every macroeconomist to be the cure for trade deficits. Recently, they have recommended it to Greece, arguing for the reintroduction of the drachma in order that the Greek economy can become competitive and rebalanced. This widespread assumption is easily demonstrated to be incorrect. Empirical evidence confirms the error. In the post-World War II years, Germany and Japan were the strongest exporting nations, despite consistent increases in their exchange rates and Britain was consistently the weakest, despite the sought after benefit of sterling depreciation. Hong Kong ignored currency management entirely in favour of a currency board tied rigidly to the U.S. dollar. However, despite having to import everything, Hong Kong managed very well … The benefit to an economy from a falling currency can only be transitory, before the benefits of lower domestic production and processing costs are outweighed by rising external costs and domestic price inflation.

  The lobby interest, which helps explain why devaluation has widespread support, is of a transfer of profits and capital values in favour of exporters at the expense of all other economic participants. No wonder the multinationals favour a lower currency. They stand to benefit the most, yet it is to these same companies that politicians turn for guidance on industrial policy and often for campaign funding. So, the push for managing currency exchange rates obviously has vested interests at its heart.

In a sound money economy free from government interventions, consumers as well as buyers of raw materials and capital goods, pay for all their purchases out of their own production, money merely being the means of exchange. In other words, imports are always paid for by exports, with any tendency for an imbalance in prices adjusted through the exchange rate. This must hold true except where an expansion of credit is involved. An individual drawing on bank credit is bringing forward future consumption. If bank credit as a whole is stable, then the effect on the trade balance will tend to be neutral. However, if banks as a whole are expanding credit, then there is a cyclical effect, which may lead to a temporary trade deficit. Furthermore, the lower interest rates associated with a credit expansion accelerates the bringing forward of consumption by discouraging saving.

In this case, the distortion comes from a credit-induced business cycle for which central bank monetary policy is always the culprit, but it is reversed later in the credit cycle if bank credit is permitted to contract without a corresponding increase in narrow money supply. Therefore, a credit cycle on its own does not lead to a persistent trade deficit. An expansionary monetary policy designed to counteract credit contraction is another matter, because it will tend to offset the cyclical correction. Government intervention by deficit spending is a further distortion on the trade balance and often the overriding factor. For a while, there may be a trade-off between contracting bank credit and the stimulus of government spending, but this hobbles the economy by discouraging the reallocation of resources from businesses no longer demanded in the market economy. Therefore, overall capacity is compromised by growing levels of malinvestment and the domestic economy becomes less efficient at satisfying demand. Thus, deficit spending cannot be satisfied by domestic production without a significant increase in prices, but it can be by more efficient foreign production. Inevitably, a trade deficit then arises to satisfy this excess demand.

This is a simplified explanation of how excess government spending worsens the balance of trade, which is the opposite of the intended effect. It is known as the twin deficit hypothesis and there are numerous empirical examples that bear this out. In Greece's case, recommendations for devaluation through a new drachma has more to do with a more hoped-for smooth transfer of wealth from domestic depositors to foreign creditors in an ironic reversal of the old cliché about being wary of Greeks bearing gifts. Recommendations to make the Greek economy competitive or rebalanced are no more than strawman arguments. The only cure for trade deficits is to reduce government intervention and let the private sector manage itself.

FRIDAY, JUNE 26TH

- The Reuters / University of Michigan group reports their index of consumer sentiment rose to a final reading of 96.1in June, following a level of 90.7 in May, citing for the first half of 2015 consumers voiced the largest and most sustained increase in economic optimism since 2004.

- Front Page Headline, Mineweb – "China Plans to Launch Renminbi Gold Fix by End of 2015. In an attempt to enable the world's biggest bullion producer and consumer more influence over gold pricing, China will launch this initiative via the Shanghai Gold Exchange (SGE). The first public confirmation from an SGE official comes after Reuters cited sources last February regarding the proposal. At a recent London Bullion Market Association (LBMA) forum in Shanghai, SGE Vice President Shen Gang stated:'We will be introducing a renminbi-denominated fix at the right moment and we are hoping that will be by the end of the year.' While Mr. Gang did not release more details, Pan Gongsheng, a Deputy Governor of the People's Bank of China (PBOC) noted: 'The PBOC will continue to support a speedy and healthy growth of the Chinese gold market.'

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CLOSING LEVELS FOR FRIDAY, JUNE 26TH.		WEEKLY CHANGE
Dow Jones Industrial Average	17,946.68	– 67.60 points
Spot Gold Bullion	$1,173.20 (U.S.)	– $28.70 per troy oz.
Spot Silver	$15.77 (U.S.)	– $0.29 per troy oz.
S&P / TSX Composite	14,808.09	+ 154.97 points
10 –Year U.S. Treasury Yield	2.47%	+ 21 basis points
10 – Year Gov't. Canada Yield	1.87%	+ 6 basis points
10 – Year Sovereign Yield Spread	60 basis points	+15 basis points
Canadian Dollar	81.20 cents (U.S.)	– 0.33 cent
U.S. Dollar Index Future	95.399	+ 1.334 cents
WTI Crude Oil Futures	$59.63 (U.S.)	+ $0.02 per barrel
DJIA / Gold Ratio	15.297	+ 0.309 point
Gold / Silver Ratio	74.394	– 0.444 point

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