

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



Monday, January 19th

Front Page Headline, MarketWatch News – “Moody’s Downgrades Russia’s Sovereign Debt Credit Rating. Late on Friday, Moody’s Investors Service downgraded Russia’s credit rating to Baa3 from Baa2 with a

MONDAY, JANUARY 19TH

Martin Luther King Jr. Holiday in U.S.

negative outlook, citing: “The substantial oil price decline and exchange rate shock will further undermine Russia’s already subdued economic growth prospects over the medium term. Moody’s also has near term concerns regarding the negative impact on the government’s financial strength due to the erosion of official foreign exchange buffers and fiscal revenues. Moody’s expects Russia’s gross domestic product (GDP) will contract by about 5.5% in 2015 and by 3% in 2016.”

TUESDAY, JANUARY 20TH

- Front Page Headline, Bloomberg News – “IMF Lowers Global Economic Growth Forecast. In its quarterly global economic outlook released today, the Washington-based International Monetary Fund not only, lowered its forecast for global economic growth to 3.5% for 2015 – down from the 3.8% pace projected last October – but also, lowered its growth outlook for 2016 to 3.7%, down from the previously projected 4% rate. At a press briefing in Beijing, Olivier Blanchard, the IMF’s chief economist, cited: ‘The world economy is facing strong and complex cross currents. On the one hand, major economies are benefitting from the decline in the price of oil. On the other hand, in many regions of the world lower long-term economic growth prospects adversely affect demand, resulting in a strong undertow.’ The IMF reduced its 2015 gross domestic product (GDP) outlook for Canada, the euro zone, Japan, China, Latin America, Russia and Saudi Arabia. The exception is the U.S. where the IMF

raised its GDP outlook for 2015 to 3.6%, up from its 3.1% forecast of last October.



IMF Managing Director Christine Lagarde  
Photo source: Bloomberg News

- Statistics Canada reports the nation’s factory sales declined by 1.4% to \$51.5 billion (CAD) in November, following a revised drop of 1.1% in October, previously reported as a decline of 0.6%.
- The National Association of Home Builders (NAHB) reports its U.S. builder confidence index for new single family homes declined to a seasonally adjusted reading of 57 in January from a level of 58 in December. A reading over 50 means a majority of builders sees conditions as generally positive.

- The National Bureau of Statistics reports China's gross domestic product (GDP) expanded by 7.4% in 2014, following a growth rate of 7.7% in 2013. In a research memorandum, Andrew Colquhoun, an analyst at Fitch Ratings, noted: "We are expecting a 6.8% GDP growth rate for China this year, slowing to 6.5% in 2016." Separately, Julian Evans-Pritchard, an economist at Capital Economics, commented: "A lot of the Chinese companies which are heavily indebted are state-owned enterprises. However, they are also the ones that have access to credit, whereas the availability of credit to privately-owned companies is limited." Meanwhile, according to officials familiar with the plan, China's Finance Ministry is accelerating its program to give farmers 4 billion yuan (\$643.7 million U.S.) in subsidies which can be used to purchase farming equipment."

\$19 million (U.S.) to the New York and Massachusetts attorneys-general offices.

- The Commerce Department reports U.S. housing starts rose by 4.4% to an annual pace of 1.09 million units in December – led by single-family home construction – following a rate of 1.04 million units in November. Moreover, the annual pace for building permits issued for single-family home construction rose by 4.5%, the fastest rate since January 2008.



Construction crew works on a new home in Leland, N.C.  
Photo source: Associated Press

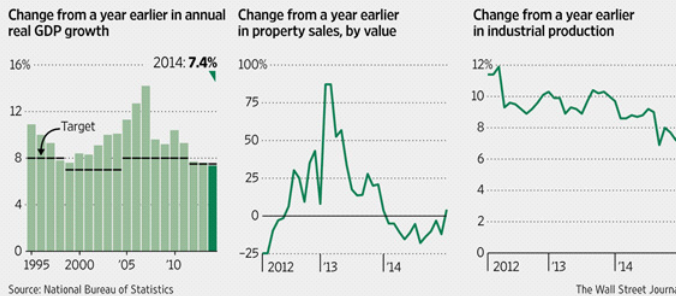
- Front Page Headline, Globe and Mail – "Bank of Canada Lowers Bank Rate to 0.75%. Following its monthly monetary policy meeting, the Bank of Canada announced it is lowering its administered overnight lending rate to 0.75% from 1%, warning: 'Lower oil prices will make a sizeable dent in the nation's gross domestic product (GDP) growth this year, delay a return to full economic capacity and reduce business investment ... Moreover, the oil price shock increases both downside risks to the inflation profile and the country's financial stability. The Bank's monetary policy action is intended to provide insurance against these risks ... The ramifications of the oil price shock for household imbalances will depend importantly on the impact of the shock on income and employment.'"



Bank of Canada Governor Stephen Poloz.  
Photo source: Reuters

**Downshifting**

After decades of near double-digit growth, China's economy is slowing, weighed down by slumping real estate and weaker manufacturing.



- In a new study entitled 'Regional Shakeup: The Impact of Lower Oil Prices on Canada's Economy,' the Conference Board of Canada warns: "The dramatic decline in world crude oil prices since last June will have a major impact on Canada, one of the largest oil producers in the world. We foresee the slide in crude oil prices will carve \$4.5 billion (CAD) from provincial royalties in 2015, with the bulk of the losses expected to strike the oil producing regions of Alberta, Saskatchewan, Newfoundland and Labrador. The Board also predicts provincial tax revenues will decline by another \$5.2 billion (CAD) this year. Moreover, Canada's federal government will share in the revenue pain in the amount of \$4.3 billion (CAD) in 2015."

WEDNESDAY, JANUARY 21ST

- Front Page Headline, MarketWatch News – "S&P Faces One Year Ban on Rating Some CMBS. The Securities and Exchange Commission (SEC) has issued three orders against Standard & Poor's, citing: 'it misrepresented its rating methodology; published a false and misleading article and allowed breakdowns in its ratings surveillance of residential mortgage-backed securities.' In settlement, S&P will pay the SEC \$58 million (U.S.) and



- Statistics Canada reports the nation's wholesale trade declined by 0.3% to \$54.03 billion (CAD) in November, down from a record high of \$54.18 billion (CAD) in October. Three of seven sectors recorded lower sales in November, led by the machinery, equipment and supplies subsector, which declined by 2.8%. The building materials and supplies subsector recorded a 1.7% decline in sales, while the farm products subsector had a drop of 7.3%.

THURSDAY, JANUARY 22ND

- The Federal Housing Finance Agency (FHFA) reports its U.S. house price index rose by a seasonally adjusted 0.8% in November, following a revised 0.4% gain in October, previously reported as 0.6%.
- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 10,000 to 307,000 in the week ended January 17th. while continuing claims increased by 15,000 to 2.44 million in the week ended January 10th. Ralph Babb, CEO of Comerica Inc. – a Dallas, Texas-based financial services company – commented: 'We expect a stronger labor market, more business activity and solid consumer spending to be positive factors for the domestic economy in 2015. However, geopolitical tensions and a weaker euro zone economy could prove to be headwinds.'
- Front Page Headline, Bloomberg News – "ECB Launches Expanded QE Program. At a Frankfurt press conference, European Central Bank President Mario Draghi announces a commitment to a 1.1 trillion euro (\$1.3 trillion U.S.) quantitative easing program, in an attempt to counter the threat of an EMU economic deflationary spiral. Despite some opposition from German officials – including Bundesbank President Jens Weidmann and German member of the ECB's Executive Board Sabine Lautenschlaeger – Mr. Draghi pledged to purchase 60 billion euros of European sovereign debt and to a lesser extent the securities of European institutions, on a monthly basis commencing in March 2015 through September 2016. Mr. Draghi stated: 'The ECB has decided to launch an expanded asset-purchase program encompassing the existing purchase programs of ABS and covered bonds. We see sustained adjustment in the path of inflation, which is consistent with achieving our target of an inflation rate just shy of 2%.'



European Central Bank President Mario Draghi.  
Photo Source: Bloomberg News

**The Variables of QE**

The ECB will balance national central banks' share of the ECB's capital and their credit ratings, plus some additional eligibility criteria for countries receiving EU-IMF assistance, to determine the proportion of individual member states' debt to be bought in its asset-purchase program.

Countries	Capital keys*	Debt, in billions	Investment grade   Junk			
			Credit-rating agencies			
			Moody's	S&P	Fitch	DBRS
Germany	25.6%	€1,320.40	Aaa	AAA	AAA	AAA
France	20.1	1,361.11	Aa1	AA	AA	AAA
Italy	17.5	1,466.23	Baa2	BBB-	BBB+	A (low)
Spain	12.6	680.56	Baa2	BBB	BBB+	A (low)
Netherlands	5.7	296.24	Aaa	AA+	AAA	AAA
Belgium	3.5	300.62	Aa3	AA	AA	AA (high)
Greece	2.9	60.96	Caa1	B	B	B
Austria	2.8	182.57	Aaa	AA+	AAA	AAA
Portugal	2.5	96.50	Ba1	BB	BB+	BBB (low)
Finland	1.8	85.53	Aaa	AA+	AAA	AAA
Ireland	1.6	114.10	Baa1	A	A-	A (low)
Slovakia	1.1	34.21	A2	A	A+	N.A.
Lithuania	0.6	–	Baa1	A-	A-	N.A.
Slovenia	0.5	21.91	Ba1	A-	BBB+	N.A.
Latvia	0.4	5.41	Baa1	A-	A-	N.A.
Estonia	0.3	–	A1	AA-	A+	N.A.
Luxembourg	0.3	6.25	Aaa	AAA	AAA	N.A.
Cyprus	0.2	5.06	B3	B+	B-	B
Malta	0.1	5.31	A3	BBB+	A	N.A.

\*The capital key refers to national central banks' contribution to the ECB's capital, based on each country's GDP and population. The capital key percentages are adjusted to exclude non eurozone countries  
Debt issued in all currencies, with an original and remaining maturity of longer than a year. ECB does not track Estonia and Lithuania's debt.  
Source: ECB (capital keys, debt), ratings agencies (ratings) The Wall Street Journal

- Front Page Headline, Globe and Mail – "RBC Buys City National Corp. In a \$5.4 billion (U.S.) takeover, the Royal Bank of Canada announces it is acquiring Los Angeles-based City National Corp. – known as a private bank and a business bank – which serves high net worth Hollywood stars, as well as commercial clients in major American urban areas, including New York, Los Angeles and San Francisco.

- Front Page Headline, Financial Times – “ECB Can Only Buy Time for Europe’s Politicians. In an op-ed, Mohamed El-Erian, chief economic advisor to Allianz, writes: ‘With Europe struggling and future expectations turning decisively negative, the European Central Bank surprised markets by committing to a large open-ended and unambiguous policy measure. In delivering a policy response that far exceeds market expectations, the central bank succeeds both in breaking the vicious cycle of self-fulfilling expectation and in setting the stage for an impressive subsequent economic recovery. That is what happened in July, 2012, when ECB President Mario Draghi used a panel appearance at the Global Investment Conference in London to state that the central bank was ‘ready to do whatever it takes to preserve the euro.’ To make his point even stronger and unambiguous, he added: ‘Believe me, it will be enough.’ It was one of the most impressive examples of successful central bank expectation management and it succeeded in calming highly volatile financial markets which were on the verge of destroying the eurozone by fragmenting Europe’s historic project of regional integration. It did so without any actual financial resources having to be deployed. In point of fact, the central bank’s balance sheet actually shrunk during subsequent quarters.

The ECB is hoping for a similar outcome today even though it is operating in a less permissive political context. By necessity rather than choice, it finds itself leading the battle against low economic growth and the threat of a sustained deflation. To this end, Mario Draghi and his colleagues on the governing council announced that from March until at least September 2016, the ECB will expand its asset purchasing program to the total of 60 billion euros per month. This implies that in 18 months, the ECB’s balance sheet will be 1 trillion euros bigger and it could be larger if inflation undershoots. The ECB is even willing to buy bonds at negative yield levels. This represents an unprecedented ECB intervention. The central bank is again signaling its steadfast commitment to Europe’s well-being. Yet, there are three reasons why the outcome will likely be mixed, i.e. meeting the intermediate financial objectives, but not the ultimate macroeconomic ones. Firstly, although some details of the announcement surprised the markets – notably the size of the ECB’s intervention – it was in line with expectations.

Secondly, the measures are not quite as open-minded as Mr. Draghi’s previous commitment in 2012. This could undermine their effectiveness, especially given that they arrive in the context of tricky political compromises. Thirdly, the ECB is now pursuing much bolder macroeconomic objectives, with inevitably imperfect tools. Rather than preventing fragmentation and

dysfunction in financial markets, the central bank is looking to deliver outcomes which actually depend upon policy adjustments largely beyond the reach of its own tools. When it comes to pro-economic structural reforms, a rebalancing of demand, combating excessive indebtedness and completing an economic union among euro zone member countries, the ECB is dependent upon political actors. This is not to say that the ECB’s announcement will have no consequences. The additional injection of liquidity will support the value of equities and other risk assets. It will mean most euro zone governments, even in the more vulnerable periphery, can borrow at interest rates closer to those enjoyed by Germany; although there will be exceptions. It will also exert further downward pressure on the euro, already near its weakest level in 11 years.

However, this is unlikely to be sufficient to deliver a breakthrough in economic growth, or to decisively alter inflationary expectations and it comes with the risk of collateral damage and unintended consequences. Last week’s Swiss franc disruptions illustrate the lesson that large movements among the world’s major currencies tend to break things. Then, there is the cost of inserting the ECB deeper into political controversies that risk undermining its future effectiveness. The ECB had little choice today but to implement an unprecedented set of measures. The best it can realistically hope to achieve is to buy time for the continent’s politicians to step up to their important economic policy responsibilities. If they fail to do so, the ECB will find itself losing effectiveness while stuck in a rather uncomfortable position; one in which it fails to deliver on important objectives, yet is unable to move without causing collateral damage.”

#### FRIDAY, JANUARY 23RD

- The New York-based Conference Board reports its U.S. index of leading economic indicators (LEI) rose by 0.5% in December. Ataman Ozyildirim, an economist at the Conference Board, commented: “December’s gain in the LEI was driven by a majority of its components suggesting the short-term outlook is brightening and the domestic economy continues to build momentum. Nevertheless, a lack of growth in residential construction, some weakness in industrial production and average weekly hours in the manufacturing sector remain a concern.”
- The National Association of Realtors (NAR) reports U.S. existing home sales rose by 2.4% in December to a seasonally adjusted annual pace of 5.04 million units, following a revised rate of 4.92 million units in November. Meanwhile, the median sale price increased to \$208,500 (U.S.) in 2014, up by 5.8% from 2013.

- Markit Economics reports the initial reading of its U.S. purchasing managers' index (PMI) for manufacturing declined slightly to 53.7 in January from a level of 53.9 in December; the lowest reading in 12 months. The initial PMI estimate is typically based upon 85% - 90% of total survey responses each month and any reading above 50 indicates expanding business activity.
- The HSBC Holdings / Markit Economics group reports their preliminary purchasing managers' index (PMI) for China's manufacturing sector rose slightly in January to a reading of 49.8, up from a level of 49.6 in December. Julian Evans-Pritchard, an economist at Capital Economics, noted: "Despite the small PMI gain, China's economy still faces headwinds, particularly in the property sector. The Bank of China is likely to wait for the stock market to correct before taking more meaningful measures, such as reducing the bank's required reserve ratios, or lowering benchmark interest rates."
- Statistics Canada reports the nation's consumer price index (CPI) rose by 1.5% in December on a year-over-year basis, somewhat lower than the 2% annual rate recorded in November, due to plunging fuel prices. Statscan cited that the price of gasoline fell by 9.8% in December and was down by 16.6% on a year-over-year basis. Fuel prices comprise nearly 5% of the CPI, so their decline accounted for most of the monthly drop.
- Front Page Headline, David Stockman's Contra Corner – "Central Bank Prophet Fears QE Warfare Pushing World Financial System out of Control. In a Daily Telegraph article, International Business Editor Ambrose Evans-Pritchard writes: The economic prophet who foresaw the Lehman crisis with uncanny accuracy is even more worried about the world's financial system going into 2015. Beggar-thy-neighbour devaluations are spreading to every region. All the major central banks are stoking asset bubbles deliberately to postpone the day of reckoning. This time emerging markets have been drawn into the quagmire as well, corrupted by the leakage from quantitative easing (QE) in the West. In an interview with the Daily Telegraph at the World Economic Forum in Davos, William White – the Swiss-based chairman of the OECD's Review Committee – stated: 'We are in a world that is dangerously unanchored. We're witnessing true currency wars everywhere and I have no idea where this is going to end.' Mr. White is a former chief economist with the Bank for International Settlements (BIS) – the bank of central banks –and is currently an advisor to German Chancellor Angela Merkel.

The excesses have reached almost every corner of the globe and combined public/private debt is 20% of gross domestic product (GDP) higher today. We are holding a tiger by the tail. QE in Europe is doomed to failure at this late stage and may instead draw the region into deeper difficulties. Sovereign bond yields haven't been so low since the Black Plague of the late 1340s. How much more bang can you get for your buck? QE is not going to help at all. Europe has far greater reliance than the U.S. on small and medium-sized companies and they get their money from banks, not from the bond market. Even after the stress tests, the European banks are still in a hunkering down mode. They are not lending to small firms for a variety of reasons. The interest rate differential is still going up.'

The warnings come just as the European Central Bank (ECB) prepares for a blitz of bond purchases beginning in March ... ECB President Mario Draghi hopes that bond purchases will push money out into the broader economy via a wealth effect, but critics fear this will be worse than useless if it leads to an asset bubble without gaining traction on the real economy. Classic monetarists say the ECB may end up spinning its wheels should it merely try to expand the monetary base. Mr. White proffered: 'QE is a disguised form of competitive devaluation. The Japanese are now doing it as well, however, no one can complain because the Americans started it. There is a significant risk that this is going to end badly because the Bank of Japan is funding 40% of all government spending. This could end in high deflation, or perhaps even hyperinflation. The emerging markets got on the bandwagon by resisting upward pressure on their currencies and building up enormous foreign exchange reserves. The wrinkle this time is that corporations in these countries – especially in Asia and Latin America – have borrowed \$6 trillion (U.S.), often through offshore centres. That is going to create a huge currency mismatch problem as America's interest rates rise and the U.S. dollar goes back up.'

Mr. White's warnings are ominous. He acquired great authority in his long years at the BIS arguing that global central banks were falling into a trap by holding real interest rates too low in the 1990s, effectively stealing economic growth from the future via intertemporal effects. He argues that this created a treacherous dynamic. The authorities were forced to push interest rates lower with the trough of each cycle, building up ever greater imbalances, in an ineluctable descent to the zero bound range, where monetary levers stop working properly. Under his guidance, the BIS annual reports over the three years prior to the Lehman crisis were a rising crescendo of alarm calls at a time when other global watchdogs were asleep. His legendary report in June 2008 openly discussed whether the world was on the

Mr. White warned: 'The global elastic has been stretched even further than it was in 2008 on the eve of the Great Recession.

cus of events which might prove as dangerous and intractable as the Great Depression, as indeed it was.

Mr. White elaborated: 'Central banks have been put in an invidious position, compelled to respond to a deep economic disorder that is beyond their power. The latest victim is the Swiss National Bank, which was effectively crushed last week by greater global forces, as it tried to repel safe-haven money flows into the franc. The SNB was damned whatever it tried to do ...The rush to QE is an unthinking fashion. Those who argue that the U.S. and the U.K. are experiencing faster GDP growth than Europe

because they carried out QE early are confusing correlation with casualty. The Anglo-Saxon pioneers have yet to pay the price. It's not over until the fat lady sings. There are serious side effects building up and we don't know what will happen when they try to reverse what they have done. The painful irony is that central banks may have brought about what they most feared by trying to maintain economic growth buoyant at all costs and not allowing productivity gains to drive down prices gently, as occurred in episodes of the 19th. century. Central banks have created so much debt that they may have turned a good deflation into a bad deflation after all."

#### CLOSING LEVELS FOR FRIDAY, JANUARY 23RD.

#### WEEKLY CHANGE

Dow Jones Industrial Average	17,672.60	+ 161.03 points
Spot Gold Bullion	\$1,292.60 (U.S.)	+ \$15.70 per troy oz.
Spot Silver	\$18.31 (U.S.)	+ \$0.53 per troy oz.
S&P / TSX Composite	14,779.35	+ 469.94 points
10-Year U.S. Treasury Yield	1.80%	- 4 basis points
Canadian Dollar	80.49 cents (U.S.)	- 3.07 cents
U.S. Dollar Index Future	94.994	+ 2.349 cents
WTI Crude Oil Futures	\$45.59 (U.S.)	- \$3.10 per barrel
DJIA / Gold Ratio	13.672	- 0.042 point
Gold / Silver Ratio	70.60	- 1.217 points

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