Monday May 11th, 2015

LONGWAVE group

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS

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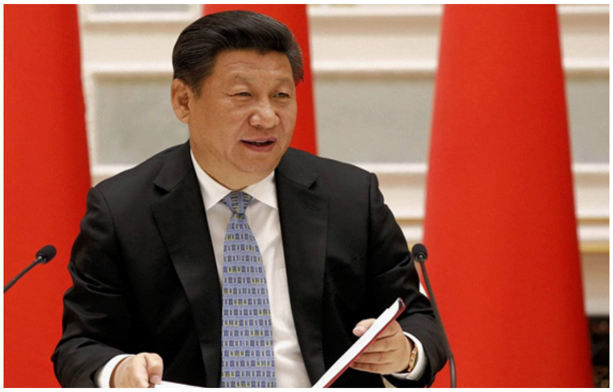
In light of a continuing economic slowdown, the People's Bank of China (PBOC) has announced a 1/ 4 of 1% cut in its benchmark lending and deposit rates effective today; the third reduction in the past six

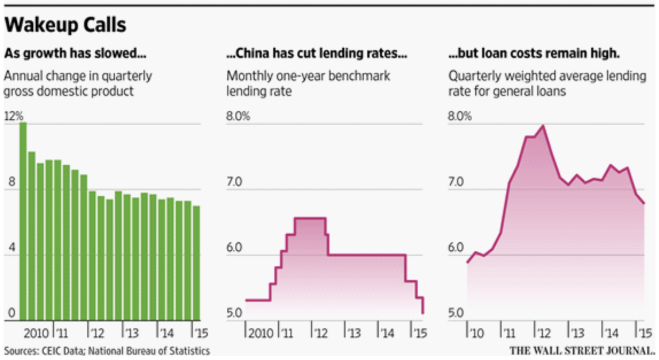
MONDAY, MAY 11TH

months. In its latest monetary policy report, the PBOC stated: "The rising debt level is forcing China to use considerable resources in repaying and rolling over debt." Last week, in a meeting of the Politburo – the Communist Party's top decision making body – Chinese President Xi Jinping stressed 'the need to channel monetary policy more efficiently to support the real economy.'



Chinese President Xi Jinping.
Source: European Press Photo Agency

Meanwhile, China's exports are expected to remain weak due to lower global demand and the nation's efforts to keep the yuan from depreciating in value. Simultaneously, bad loans are increasing within China's vast banking system. According to the China Banking Regulatory Commission, non-performing loans surged by 140 billion yuan ($22.6 billion U.S.) in the 1st. quarter to 982.5 billion yuan; the biggest quarterly increase in a decade."



- Front Page Headline, Financial Times – "German Bund Yields Will Remain Low in Historical Terms. Mohamed El-Erian, chief economic advisor to Allianz SE, writes: The normally staid market for German sovereign government bunds has been rather exciting lately. The market has soared into highly priced places and moved in an unprecedented manner. In the process, it is now a major determinant of bond yields elsewhere, including in the usually autonomous territory of U.S. Treasurys. Crowning an impressive multi-year compression, the 10-year German bund yield reached a record low of 0.05% on April 17th. Many of its peers on the German sovereign yield curve, including up to the 9-year maturity date, were trading at negative nominal yields – i.e. investors were willing to pay for the privilege of lending money to the bund issuers. Moreover, with 3 trillion euros of outstanding European debt trading at negative nominal yields, a decent sector of informed expert opinion judged that it was only a matter of time until this huge anomaly spread out even further.

Five familiar factors had driven this historic bund yield compression: depressed economic growth; disinflation which threatened to morph into deflation; the resurfacing of worries about a disorderly Grexit from the euro zone; a sizeable quantitative easing program of asset purchases by the European Central Bank (ECB) and a regulated investment community that worried about the implications of a liability mismatch at ever declining yield levels. All this was temporarily boosted by investors and hedge funds which had been short bunds and needed to cover in order to limit losses. The lower the German bund yield ventured, the greater the pressure for its U.S. Treasury counterpart to follow suit. While Treasurys did follow in direction, they didn't to such a low destination. However, like all major moves fuelled by a combination of cyclical, secular and structural issues, the risk of an overshoot was material. It was further fuelled by the notion – wrongly embraced by quite a few market participants – that the ECB could not only influence, but also determine market yields for bunds across the yield curve and well beyond the immediate reach of its policy administered rate.

Of course, there is a limit to how low bund yields can go without triggering investor resistance, especially when several maturities have their yield levels go negative. This limit was reached a few weeks ago and is now being corrected as part of a more general market reawakening that is differentiating among bond yields which had converged excessively, including those for European bonds in the peripheral area. However, the recent market correction is unlikely to translate into a snapback which will see the 10-year bund yield surge well above 1%, or U.S. Treasurys well above 3%. Instead, they will remain low in historical terms, but not ridiculously so and German bunds will continue to be the sovereign debt market from which other sovereign bond markets take their cue. Global gross domestic product (GDP) growth and inflation prospects, while not as dire as a few months ago, are still far from robust. The slow and careful decoupling of U.S. Federal Reserve monetary policy, notwithstanding, the central bank community remains ultra-loose, with the likelihood of further stimulus in the months ahead in Europe and China, plus accompanied by a further decline in the supply of safe assets.

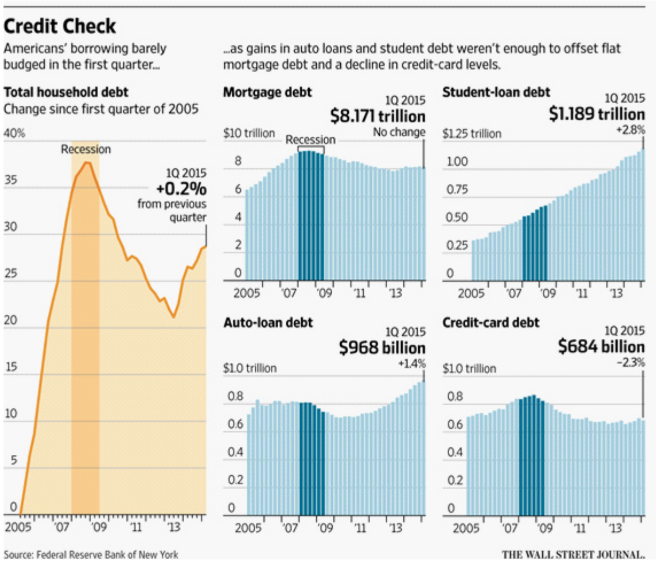
Overvaluation concerns which also extend to global equity markets constrain the flow of funds that might otherwise occur out of low yielding-bonds and into equities. The Greek situation is unlikely to be resolved any time soon and on current trends, is as likely to culminate in a messy accident as just continuing to muddle along. Moreover, the geopolitical context is far from stable, particularly with the Minsk II cease fire under growing pressure in Ukraine. Rather than a full normalization process driven by a global economy that is regaining a robust economic footing and stronger financial stability, the markets for high quality government bonds will still be littered for a while with securities that have anomalous, though less crazy yields. At the margin, this may help stimulate economic activity. However, this would come at the cost of reinforcing structural forces which are fundamentally undermining the provision of long-term financial services, such as life insurance and pensions, changing the nature of banking and still enticing investors to make decisions based upon a relative, rather than an absolute, evaluation – i.e. to choose the least absurdly rich asset."

TUESDAY, MAY 12TH

- The U.S. Treasury Department reports federal government revenues exceeded expenditures by $156.7 billion (U.S.) in April, reducing the budget deficit for the first seven months of the current fiscal year to $282.8 billion (U.S.) compared with a deficit of $306.4 billion (U.S.) over the same period a year ago. Unsurprisingly, the U.S. Congress has postponed any reset of the national debt ceiling – which was scheduled for last March 15th. – until at least the fiscal year end of September 30th. Meanwhile, the U.S. National Debt Clock has recently exceeded $18.2 trillion (U.S.) or, put another way $18,200,000,000,000 (U.S.).

- Front Page Headline, Bloomberg News – "Moody's Downgrades Chicago's Credit Rating to Junk Status. The Rating Agency cited: 'The downgrade to Ba1with a negative outlook incorporates expected growth in the City's highly elevated unfunded pension liabilities. Following the Illinois Supreme Court's recent rejection of a state pension overhaul plan, we believe that the City's options for curbing growth in its own unfunded pension liabilities have narrowed considerably."

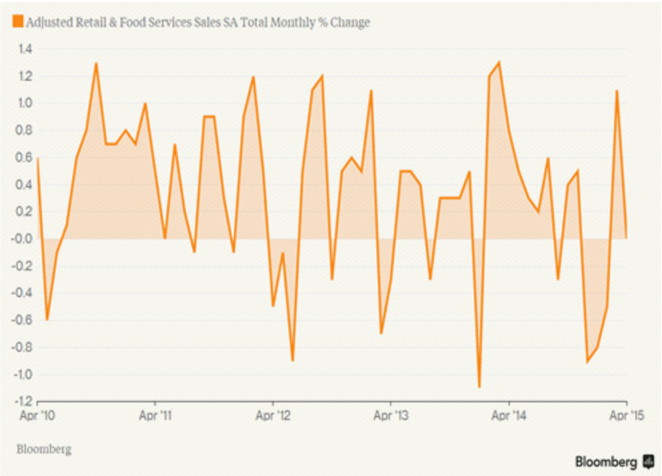
- The Federal Reserve Bank of New York reports U.S. household debt – including mortgages, credit cards, auto loans and student loans rose slightly by 0.2% to $11.85 trillion (U.S.) in the 1st. quarter. The big factor behind the muted increase was mortgage balances – which comprise the bulk of American household's overall debt – were largely unchanged at $8.17 trillion (U.S.). Mortgage debt outstanding is just $6 billion (U.S.) higher than in 2014. By contrast, in just the last quarter, auto loan balances increased by $13 billion (U.S.) to $968 billion (U.S.), while outstanding student loans increased by $32 billion (U.S.) to $1.19 trillion (U.S.).



- The German economics ministry reports the nation's industrial production, adjusted for inflation and seasonal swings, declined by 0.5% in March, citing: 'Some key economic sectors such as mechanical engineering and automobiles, currently lack momentum.'

WEDNESDAY, MAY 13TH

- The Commerce Department reports U.S. retail sales were flat in April, while sales on a year-over-year basis have slowed to a 0.9% pace, the smallest annual gain since October 2009.



- Front Page Headline, Financial Post – "Canadian Finance Minister Joe Oliver Urges Washington to Change Volcker Trading Ban. In a speech at a Canada / U.S. conference in New York, Mr. Oliver cited: 'I believe, with a strong legal basis, the U.S. ban on its banks doing proprietary trading of Canadian debt violates the terms of the North American Free Trade Agreement (NAFTA) between Canada, America and Mexico. I hope the United States administration sees that changing the Volcker rule is not only, in its own best interests, but also, in those of its biggest trading partner.' Mr. Oliver also noted that Canadian government debt is rated safer by Standard & Poor's than U.S. Treasurys – AAA v/s AA (High) – meaning it is a sound fixed income market for American banks to trade.

Canadian Finance Minister Joe Oliver.
Source; National Post

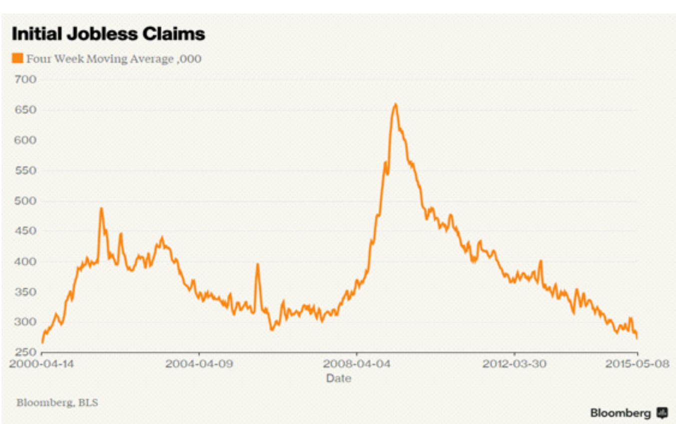
- Eurostat, the European Union's statistics agency, reports the euro zone's gross domestic product (GDP) expanded by 0.4% in the 1st. quarter, citing lower energy prices enabled a slightly higher level of consumer spending. While gross domestic product (GDP) growth improved in the French and Italian economies, these were offset by a slower economic performance in Germany; as well as the Greek economy falling back into recession. See charts below and on the following page.

- Jorg Kramer, chief economist at Commerzbank, noted: “The weaker than expected GDP result supports our warnings that many economists have become overly optimistic. Euro zone GDP growth forecasts for this year in excess of 2% now look too high. We even perceive downward risks to our conservative 1.8% GDP growth estimate.”

THURSDAY, MAY 14TH

- The Labor Department reports the U.S. producer price index (PPI) declined by 0.4% in April and by 1.3% on a year-over-year basis, citing the plunge in energy prices during the second half of 2014, subdued gross domestic product (GDP) growth and a continuing strong U.S. dollar. The core index, eliminating food, fuel and trade services, rose by 0.7% from April 2014. Jim O’Sullivan, chief economist at High Frequency Economics in Valhalla, New York, noted: “The domestic inflation rate remains very tame. If anything, it’s a little weaker.”

- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 1,000 to 264,000 in the week ended May 9th. while continuing claims held steady at 2.23 million in the week ended May 2nd.



- Front Page Headline, Globe and Mail – “Bombardier Announces 1,750 Aerospace Job Layoffs. In a press release, Bombardier Business Aircraft President Eric Martel stated: ‘We have recently witnessed an industry-wide softness in demand in certain international markets, so we are taking steps to adjust our production accordingly.’ In a statement expressing his disappointment to learn of the job layoffs, Brad Duguid, Ontario’s minister of economic development, acknowledged: ‘Bombardier has indicated that short-term demand is softening due to several international factors, including the crisis in Ukraine, economic sanctions imposed on Russia, lower GDP growth in China, the economic slowdown in Brazil and the continuing strength of the U.S. dollar.”

- Front Page Headline, Reuters News – “U.S. Rejects Canada’s Claim that Volcker Rule Violates NAFTA. In an e-mail, a U.S. Department of the Treasury spokeswoman stated: ‘The Volcker Rule is clearly not a violation of NAFTA … which explicitly safeguards the ability of the United States to protect the integrity and stability of our financial system.’ At Longwave Analytics, it is clear to us that not all of Washington’s ‘lame ducks’ are stationed at the White House.

- Front Page Headline, GoldMoney – “The Trouble with Cash. Researcher Alasdair Macleod writes: When interest rates are at zero and it costs at a bank to look after your money, it becomes an unattractive asset. Banks in some jurisdictions – such as Switzerland, Denmark and Sweden – are even charging customers interest on cash and deposits. Moreover, if one goes to his bank to withdraw large amounts in the form of folding notes in order to avoid these charges, he will be lucky if he is not treated as a sort of pariah. For the moment, at least, these problems do not extend to sound money, i.e. gold. There are two distinct issues involved with government-issued currency: zero-to-negative interest rates, which all but eliminate any interest turn on deposits for the banks and a systemic issue that arises if too many people withdraw their money from the banking system. The problems with the latter would become significant if enough people decide to effectively opt out of holding money in the banks.

  Conversion of bank deposits into physical cash increases reserve ratios, restricting the banks’ ability to create credit. However, while the banks are contractually obliged to supply physical cash to anyone who wants it, a drawdown on bank deposits is a bad thing from a central bank’s point of view. Therefore, a desire for physical cash is discouraged. Instead, if the option of owning physical cash was removed and there was only electronic money, deposits would simply be transferred from one bank to another and any imbalances between the banks resolved via the money markets, with or without the assistance of a central bank. The destabilizing effects of bank runs would be eliminated entirely.

In the current financial climate, demand for cash does not originate so much from loss of confidence in banks, with some notable exceptions such as Greece. Instead, it is a consequence of ultra-low or even negative interest rates. Therefore, the desire for cash is an unintended consequence of central banks attempting to inject confidence into the economy. The rights of ordinary individuals to turn deposits into cash are definitely resisted by central banks, which are focused instead on managing zero interest rate policies and suppressing any side effects.

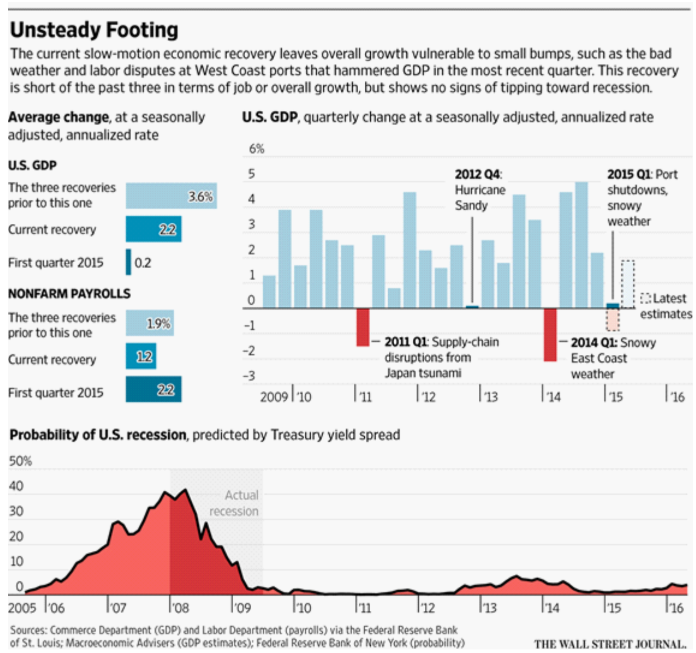
Central banks can take this logic one step further. Monetary policy is primarily intended to foster investment confidence, therefore any tendency for investors to liquidate investments is to be discouraged. However, with financial markets becoming progressively more expensive, central bankers will suspect the relative attraction of cash balances is increasing. Indeed, because banks are making cash deposits more costly, this is bound to increase demand for physical notes. Monetary policy has now become like a pressure cooker with a defective safety valve. Central bankers realize it and investors are slowly becoming aware of that as well. Add into this mix a faltering global economy – a fact which is becoming impossible to ignore – and a dash-for-cash becomes a serious potential risk to both monetary policy and the banking system.

There is an obvious alternative to cash and that is to purchase physical gold. This does not constitute a run on the banking system, because a buyer of gold uses electronic money that transfers to the seller. The problem with physical gold is a separate issue: it challenges the raison d'etre of the banking system and of government currencies as well. This is why we can still buy gold instead of encashing our deposits. It can only be a matter of time before people realize that with the cash option closing, this is the only way to escape an increasingly dysfunctional financial system."

FRIDAY, MAY 15TH

- Statistics Canada reports the nation's factory sales rose by 2.9% in March, led by gains in the aerospace and auto sectors. Overall factory sales increased in 10 of 21 industries, i.e. 60% of all Canadian manufacturing.

- The Federal Reserve reports U.S. industrial production – which measures the output of American manufacturers, utilities and mines – declined by a seasonally adjusted 0.3% in April; its fifth consecutive monthly drop. Also, capacity utilization – a measure of slack in the industrial sector – fell by 0.4% to 78.2% in April. Stephen Stanley, an economist at Amherst Pierpont, noted:'While the strong U.S.dollar has taken a toll on exports, lower oil and gas production has also affected a number of goods producing industries.'



- Front Page Headline, Mish's Global Economic Trend Analysis – "China's Steel Consumption Declines for First Time in Three Decades. Looking for signs of a global economic recovery? If so, don't look to China. Reuters reports China's apparent crude steel consumption declined for the first time in three decades in 2014 … a further indication of how the country's economic slowdown is hurting industrial demand. A decline in the usage of steel in China, which is both the top consumer and producer of the alloy will dent iron ore prices that have already been roiled by a global oversupply. Spot rates of the steel making ingredient are currently mired near a 51/2 year low at $65.60 (U.S.) per tonne. China's apparent crude steel consumption fell by 3.4% to 738.3 million tonnes in 2014 on a year-over-year basis.

  According to official data, China's power output growth declined to a 16-year low last year, while coal output likely fell for the first time in a decade. China's 2014 steel output increased by 0.9% to a record 822.7 million tonnes over 2013. The China Iron and Steel Association (CISA) commented: 'Affected by overcapacity, it is unlikely there will be either a turn around in oversupply in the steel product market, or any big recovery in prices.' This is all part of China's painful rebalancing process that is really just beginning. Commodity exporters like Australia and Canada are caught in the cross hairs. While prices may or may not stabilize at this point, they are highly unlikely to shoot higher and remain higher. China's transition from infrastructure and housing to consumer consumption will take many years. Moreover, China's gross domestic product (GDP) will gradually sink – far more than most people believe possible – until that process is complete. Two percent GDP growth down from seven per cent is along the lines of what I have in mind. Of course, that presumes one believes China's GDP is currently growing at 7%."

CLOSING LEVELS FOR FRIDAY, MAY 15TH.		WEEKLY CHANGE
Dow Jones Industrial Average	18,272.56	+ 81.45 points
Spot Gold Bullion	$1,225.30 (U.S.)	+ $36.40 per troy oz.
Spot Silver	$17.53 (U.S.)	+ $1.09 per troy oz.
S&P / TSX Composite	15,108.12	– 61.90 points
10 – Year U.S. Treasury Yield	2.14%	– 1 basis point
Canadian Dollar	83.18 cents (U.S.)	+ 0.47 cent
U.S. Dollar Index Future	93.23	– 1.588 cents
WTI Crude Oil Futures	$59.69 (U.S.)	+ $0.30 per barrel
DJIA / Gold Ratio	15.073	– 0.227 point
Gold / Silver Ratio	69.90	– 2.418 points

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