

UNDERSTANDING THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

THAT WAS THE WEEK THAT WAS



Monday, August 23RD

In a Wall Street Journal article entitled Rethinking Gold: What if It Isn't a Commodity After All? journalist and author Jeff Opdyke cites:

MONDAY, AUGUST 23RD

"For investors convinced U.S. lawmakers and central bankers will successfully manage the budgetary woes and the massive unfunded liabilities of Social Security and Medicare, then gold is overvalued in the long term ... If, however, you worry the U.S. balance sheet is irreparably damaged, then gold currently reflects the likelihood that a weak U.S. dollar trend still has years to run as the U.S. struggles with its financial mess. Investors – and consumers – looking to preserve their purchasing power will gravitate toward gold, since its quantity isn't easily manipulated. Invest in gold, then, according to your beliefs about the future of the U.S. greenback." The light bulb finally goes on in the media mindset. See also, Winter Warning – The Die Is Cast and Put Not Your Trust In Princes, September 22, 2008

A Shadow Currency

As the chart below shows, gold—which closely mirrors the dollar's moves—often acts more like a currency than a commodity.



Sources: Federal Reserve; WSJ research

- In a Wall Street Journal article, reporter Katy Burne suggests some American “(investment) bankers have recently begun sounding out (institutional) investors about (purchasing potential new issues of) 100-year (corporate) bonds. With interest rates (and corporate bond yields) now at some of their lowest levels in history, some companies are tempted to press for longer-dated paper, knowing that (investor) demand for corporate bonds is (currently) outstripping supply.” Historically low corporate bond yields, notwithstanding, at Longwave Analytics, we believe any attempt at launching a century bond issue in the current market would represent a formidable challenge because of a dearth of willing buyers. Century bonds experienced a novelty popularity between 1995 and 2005 with several highly rated corporate entities, ranging from International Business Machines to Norfolk Southern Corp. Indeed, Norfolk Southern issued \$650 million (U.S.) of 7.02% bonds maturing in 2097 and 2105 at a time when the 30-year to 100-year yield spread was a mere 15 basis points. Since some century bond issues are now trading in the range of a 5.40% yield basis, today the existing yield spread is closer to 75 basis points. In any event, because a 100-year maturity eclipses the very longest of possible business cycles by at least 25 to 30 years, such maturities would prove to be illiquid orphans in any institutional investment portfolio.
- Ethan Harris, the Bank of America’s chief North American economist, warns early (economic) data for August suggest that “an already weak recovery is getting weaker. Politicians are clamouring for quick action, not to stimulate a dangerously weak

(U.S.) economy, but to reduce the (federal) budget deficit. We strongly support efforts to reduce the deficit, but only once the economy is on a healthy growth trajectory. The most pressing concern to us is that absent new legislation, all of the Bush tax cuts will expire at the end of this year. We estimate that would represent a 2% hit to household income. If such an increase were not reversed, we believe it could trigger a double-dip recession.”

On the one hand, it's nice to see that the B of A supports efforts to reduce the U.S. federal deficit. On the other hand, if we must wait until the U.S. “economy is on a healthy growth trajectory,” be assured, we will have a long, long wait indeed. Presently, the U.S. national debt stands at \$13.5 trillion and is increasing at the rate of \$4.2 million (U.S.) a minute.

TUESDAY, AUGUST 24TH

- The National Association of Realtors reports U.S. existing home sales declined by 27.2% to a seasonally adjusted annual rate of 3.83 million in July, from a 5.26 million annual rate in June, citing the expiration of the temporary 8% federal tax credit at the end of April. Sales of single-family dwellings fell to their lowest rate in 15 years.
- In an address to the City Club of Cleveland, U.S. House of Representatives Minority Leader, John Boehner (R.Ohio) commented: “President Obama should ask for – and accept – the resignations of the remaining members of his economic team, starting with Treasury Secretary Geithner and Chairman of the National Economic Council, Larry Summers.” In his comments, Mr. Boehner argued that “virtually” no one in the White House has experience operating a small business and creating jobs in the private sector. Mr. Boehner further asserted that President Obama should cancel his plan to impose “job-killing tax hikes on families and small businesses” and consider an aggressive spending reduction package.
- In a Bloomberg News interview, Utah Treasurer Richard Ellis, attending a National Association of State Treasurers meeting in Williamsburg, Virginia, stated that federal government financial assistance “provides a little bit of a bridge, but ultimately, states are going to have to make tough decisions and cut programs. The 2012 fiscal year, which begins next July for most states, will be difficult across the country because officials haven't cut spending enough, to keep it in line with their diminished revenue.”

- Standard & Poors (S&P) downgrades Ireland's sovereign credit rating from 'AA' to 'AA' (Low), citing: “Another downgrade is possible if the fiscal cost of supporting the banking sector rises further; or if other adverse economic developments weaken the government's ability to meet its medium-term fiscal objectives. Our new projections suggest that Ireland's net general government debt will rise toward 113% of gross domestic product (GDP) in 2012. That's more than 1.5 times the median for the average of euro zone sovereign nations, and well above the debt burdens it projects for similarly rated countries in the region; such as Belgium at 98% and Spain at 65%.”
- The Bank of Montreal (BMO) reports a net profit of \$669 million (CAD) in the 3rd. fiscal quarter ended July 31st., compared with a net profit of \$557 million (CAD) in the same period a year ago; but citing a significant decline in trading revenues in its investment banking division
- Statistics Canada reports Canadian retail sales rose by 0.1% in June, citing most of the increase was in motor vehicle sales and parts
- Destatis, Germany's Federal Statistics Office, reports the general government budget deficit increased to 42.8 billion euros (\$54.2 billion U.S.), or 3.5% of GDP, in the first half of 2010; citing the huge cost of bailing out some of the country's banks, including 900 million euros due to the assumption of bad debts from Dusseldorf-based WestLB (formerly, Westdeutsche Landesbank Girozentrale)
- In recent U.S. Federal Court filings, the Securities & Exchange Commission (SEC) alleges that Countrywide Financial's former chief Executive officer, Angelo Mozilo, approved mortgage loans for favoured borrowers that contradicted the company's lending policies. In its pending civil fraud case, it appears to be the first time that the SEC has addressed Mr. Mozilo's role in the controversial VIP lending program, where some borrowers received better mortgage loan terms and services than were generally available. Some of the mortgagees were public officials.

WEDNESDAY, AUGUST 25TH

- Portugal launches a 1.3 billion euro (\$1.6 billion U.S.) bond issue comprised of two tranches: 629 million euros of 5-year bonds at an average yield of 4.371% and 672 million euros of 10-year bonds at an average yield of 5.312%. While yields to maturity were slightly higher than prior issues, the bid-to-cover ratios were unchanged at 1.8 times and 2.0 times, respectively.

- The Commerce Department reports U.S. orders for durable goods rose by 0.3% in July, following an upwardly revised decline of 0.1% in June, previously reported as a drop of 1.2%. Ex-transportation, durable goods orders fell by 3.8% in July.
- The Canadian Imperial Bank of Commerce (CIBC) reports a net profit of 640 million (CAD) in its 3rd. fiscal quarter ended July 31st., citing lower loan loss provisions of \$221 million (CAD) and reduced exposure to the investment banking sector which suffered from lower trading revenues
- The Commerce Department reports U.S. new home sales declined by 12.4% to a seasonally adjusted annual rate of 276,000 units in July, following a downwardly revised annual rate of 315,000 units in June, previously reported as 330,000 units
- The World Gold Council (WGC) reports global gold demand rose by 36% to 1,050 tonnes in the 2nd. quarter, mainly due to strong demand for gold exchange traded funds (ETFs), which grew by 414%. Global demand for physical gold bars rose by 29%, while jewellery demand remained robust but about 5% lower than in the same period a year ago.
- According to the Teranet—National Bank composite house price index, Canadian house prices rose by 13.6% in June on a year-over-year basis. Conference Board of Canada Associate Director Michael Burt commented: “Most of the costs associated with home ownership, such as mortgage costs and insurance, are outstripping inflation and income growth. As a result, housing affordability in Canada, which has been deteriorating over the last decade, will continue to decline during the next two years.”
- The Confederation of British Industry / Distributive Trades Survey’s retail sales balance rose to a reading of +35 in August from a level of +33 in July, citing higher demand resulting from discount sales, warmer weather and summer tourist traffic
- The Mortgage Bankers Association reports that while the number of American homes in the process of foreclosure declined in the 2nd. quarter; the delinquency rate (the percentage of mortgagees at least one month behind in their payments) rose to a level of 3.51% during the second quarter from a level of 3.31% at the end of 2009
- In a research report, Arnaud Mares, an executive director at Morgan Stanley in London, warns: “Governments will impose a loss on some of their stakeholders. The question is not whether they will renege on their promises, but rather, upon which of their promises will they renege and what form this default will take? The sovereign debt crisis is global and it is not over. Debt as a percentage of gross domestic product (GDP) is a false indicator of an economy’s health, given it doesn’t reflect governments’ available revenue and is backward-looking. While the U.S. Government’s debt is 53% of GDP, one of the lowest ratios among developed nations, its debt is 358% of revenue, one of the highest.”

THURSDAY, AUGUST 26TH

- The Labor Department reports U.S. initial claims for state unemployment benefits declined by 31,000 to 473,000 in the week of August 21st. from an upwardly revised level of 504,000 the previous week. Continuing claims declined by 62,000 to 4.46 million in the week ended August 14th.
- The Royal Bank of Canada reports net earnings of \$1.28 billion (CAD) for its 3rd. fiscal quarter ended July 31st., compared to earnings of \$1.56 billion (CAD) in the same period a year ago. In a statement, the bank cited: “Capital Markets was impacted by lower trading results due to challenging market conditions. Specifically, concerns over the global economic recovery, (the) European sovereign debt crisis, U.S. regulatory reform and (market) volatility resulted in significantly lower client activity, tightening (loan interest) spreads and higher funding costs.”
- The National Bank of Canada reports net earnings of \$271 million (CAD) in the 3rd. fiscal quarter ended July 31st. President and Chief Executive Officer Louis Vachon commented: “The third quarter results demonstrated excellent performance in the personal and commercial segments and a credit portfolio of good quality. Despite less favourable conditions for trading activities, the financial markets segment maintained sound profitability.”

FRIDAY, AUGUST 27TH

- The Commerce Department downwardly revises its estimate for 2nd. quarter U.S. gross domestic product (GDP) growth to 1.6% from its previous preliminary estimate of 2.4%, following the 3.7% annual growth rate reported for the 1st. quarter
- The Finance Department reports Canada’s federal deficit totaled \$7.2 billion (CAD) in its 1st. fiscal quarter ended June 30th. compared to \$12.5 billion (CAD) in the same period a year ago, cautioning that while there is “considerable uncertainty” about the strength of the global economic recovery, the 3-month , shortfall is “broadly consistent” with Finance Minister Flaherty’s projection of a \$49 billion (CAD) deficit for the current fiscal year

- Speaking at the Kansas City Fed's annual monetary symposium, held in Jackson Hole, Wyoming, U.S. Federal Reserve Board chairman Ben Bernanke stated "the economic outlook is inherently uncertain and the (U.S.) economy remains vulnerable to unexpected developments. The Federal Open Market Committee (FOMC) is prepared to provide additional monetary accommodation through unconventional measures if it proves necessary; especially if the (U.S. economic) outlook were to deteriorate significantly."
At Longwave Analytics, we believe few arrows remain in the Fed's quiver. Since the Fed Funds and fiscal stimulus arrows have already departed the bowstring; the structural arrows of tax reform, entitlement reform and deficit reform are the only meaningful, albeit, challenging arrows that the Obama administration has left to release.
- In a client newsletter, Albert Edwards, a market strategist for Societe Generale, warns: "Equity investors are in for a rude shock. The global economy is sliding back into recession and investors are still not even aware that these events will trigger another leg down in valuations; the third major bear market since the equity valuation bubble burst. So far, the equity market has shrugged off much of the weaker (economic) data that abounds and has not joined the bond market in a perceptible move. The equity market will though, crumble like the house of cards it is, when the nationwide (U.S.) ISM manufacturing (index) slides below a reading of 50 into recession territory in coming months." (The ISM index stood at a reading of 55.5 in July). Mr. Edwards forecast a return to the "valuation nadir last seen in 1982, with the S&P bottoming at around 450 points."
See also, Special Editions – Dow 1,000 Is Not a Silly Number, November 2009
- Attending the same economic forum as Mr. Bernanke; European Central Bank President Jean-Claude Trichet warns: "The lesson from past history is that dealing with the legacy of accumulated imbalances is not simply a duty to be fulfilled after the economic recovery, but rather an important precondition for sustaining a durable (economic) recovery. The primary macroeconomic challenge for the next 10 years is to ensure that they do not turn into another lost decade. The option of living with the debt indefinitely, is not a solution to the challenges currently facing policy makers. So, given the size of the accumulated public debt, fiscal consolidation will have to be ambitious."
Soon after the November 2nd. U.S. mid-term elections and the December report from President Obama's National Commission on Fiscal Responsibility and Reform, we reiterate our prediction of an economic civil war erupting between fiscal liberals and conservatives, especially if political gridlock has become entrenched in Washington
- United Airlines and Continental Airlines win U.S. Justice department approval for an October 1st. merger, after ceding 18 daily round trip flights to Southwest Airlines in Newark, New Jersey

CLOSING LEVELS FOR FRIDAY, AUGUST 27th.		WEEKLY CHANGE
Dow Jones Industrial Average	10,150.70	– 62.90 points
Spot Gold Bullion (December)	\$1,237.90 (U.S.)	+ \$8.20 per ounce
S&P/TSX	11,879.70	+ 157.60 points

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