Quote of the week : "Sooner or later everyone sits down to a banquet of consequences" - Robert Louis Stevenson (a lifetime sickly, but well-traveled, Scot, who died in 1894 at the age of 44) - *John Mauldin used this quote in a recent weekly From the Frontlines column. In it he rather cleverly compared the age-old confluence of the strong warm Agulhas current rushing Southwest down the East African coast & the Northbound powerful cold Benguela current coming up from Antarctica that has made the Cape of Good Hope historically the world's most dangerous ocean trade route, with rogue waves of up to 80 feet capable of capsizing even the biggest of ships, with that in financial markets between the fast warm flow of QE money with the harsh cold reality of deleveraging. This in turn was a prelude to a discussion of Robert Schiller's CAPE concept [that screens out false signals in the stock market by comparing today's Price-Earnings (P/E) ratio with its 10-year, inflation-adjusted average]. On that basis, today's S&P 500's 25.6x P/E is at a level exceeded only in the late 1920's (briefly), in the late 1990's (a little longer) & in the first half of this century's first decade (barely so). It is currently also the second highest CAPE reading in all of the world's 56 stocks market (the only one higher being that of the tiny Sri Lanka stock market).*

Tomorrow Bernanke will officially hand over the reins of power at the Fed to Janet Yellen. While credited with avoiding an economic meltdown in 2008, subscribers to the Austrian School of economic thinking say doing so is akin to commending an arsonist for extinguishing a bonfire he set himself, & ignoring that in the process he had laid the foundation for another conflagration.

The preliminary Fourth Quarter US GDP growth outturn must have unpleasantly surprised those who had expected 4% QoQ growth; for it came in at only 3.2%, well down from the Third Quarter's 4.1%, resulting in only 1.9% GDP YoY growth for all of 2013 (vs. 2.3% in 2012).

The IMF is forecasting the strongest global economic growth this year since 2011 & for the first time in seven years the atmosphere at the Davos Economic Forum was said to be 'generally upbeat'. But BlackRock CEO Lawrence D. Fink rained on their parade when he told a panel in Davos on January 25th that there is "way too much optimism in financial markets" - *the wisest course usually is to "follow the money" rather than the predictions of 'salary men'.*

Ifo is a Munich-based think tank. Its Business Climate Index is based on a monthly survey of 7,000 firms. This month's reading was 110.6, up from 109.5 in December, well above the 110.0 expected & the highest in 2½ years. And while GDP growth in 2013 is expected to come in at just 0.4%, the forecast for this year is 4x that, or better, due to stronger domestic demand & exports.[1] Meanwhile, the UK economy is this year expected to be the strongest in Europe (*which must be welcome news for Prime Minister David Cameron but may pose some challenges for Bank of England Governor Mark Carney).*

President Putin must have been dismayed recently when the unrest in neighbouring Ukraine spread to the Eastern part of that country. For that's where most of the 18% of the country's population that are ethnic Russians live, and where support for President Yanukovich & his plans for a closer relationship with Russia rather than the EU is strongest. His nightmare scenario now may well be the occurrence of a terrorist incident during the Sochi Games that would encourage the Ukrainian demonstrators & reduce his ability to support Yanukovich.

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1 It is also rather interesting to note in this context that Germany is the only major country whose already relatively low (it's in the 80% range whereas the others', incl. the US', is North of 100%) debt-to-GDP ratio is expected to decline over the next couple of years.

The Argentinian peso slumped 20% last week after the government decided it had better uses for its shrinking US$30BN in currency reserves than to pour them down the drain in a lost cause, propping up the peso. Then on January 24th it announced it would lift its two year-old ban on its citizens buying foreign currencies (which will have every sensible Argentinian of any means rushing out to do so). Meanwhile in Venezuela the official exchange rate is 6.3 bolivars to the US$ whereas the black market rate is said to be 78 to the dollar - *while the Argentinian government will likely be able to muddle through, Venny's President Nicolás Maduro is in a swamp full of alligators with water up to his lips (even after supposedly having received as much as US$50BN in aid from Beijing). And both are contributing to a resurgence of "risk-off" sentiments among investors (which benefits the US dollar & UST securities, with the potential collateral damage thereof being to embolden US lawmakers to be more intransigent than prudent on the debt ceiling issue).*

The US government expects to sell a net US$717BN of debt securities this year. This is being hailed as very positive; for it would be 14% less than last year & 55% less than its all-time high net borrowing in 2010, and the least since 2008. But it would still fund 19% of the Budget & the Debt-to-GDP ratio would still rise marginally in the 100+% range. And all of this is predicated on the economy growing by 3% real [which the CBO (Congressional Budget Office) believes unrealistic]. Moreover, it may be a respite, not the onset of a trend; for while the cost of Social Security in 2013 was US$809BN (23% of total spending) & of Medicare/Medicaid US$852BN (25%), inflows into the Social Security Fund were just US$965BN (28% of total revenues), and the CBO expects the cost of the former a decade hence to be 67% higher (i.e. US$1,414TR) & the latter 100% (US$1,808TR) *which presumably doesn't include the cost of Obamacare.*

The US Treasury has reported it has been lengthening the average maturity of US government debt. But this is only part of the story. For it has achieved this by issuing growing volumes of non-marketable debt to the entitlement program 'funds' while in the marketable portion of its debt, over two thirds of the total, it has 'stayed short' to minimize its current debt service costs. So the share of marketable debt maturing in less than one year has tripled to 25%-, & that maturing between one & five years to 33%-, of the total; so, if short-term rates were to start moving up sooner than the Fed has been postulating, the impact on its borrowing costs could be rapid & dramatic. On top of that, while it makes sense to issue long bonds to the entitlement funds since they are not expected to reach the point where outgo will exceed income for some time, those are projections only, and old people are living longer & requiring more upkeep in their twilight years than forecast.

In a column in the January 30th National/Financial Post entitled <u>Tax people, not corporations</u> Philip Cross, formerly the Chief Analyst at StatsCan, says 'corporate income taxes' are in essence *indirect* taxes on individuals collected by corporations for governments (like sales taxes). So the two provinces that raised corporate income taxes rates in 2013 & NDP Leader Thomas Mulcair who advocates raising federal corporate income taxes from 15% to 22% while freezing personal income taxes, are deluding themselves; for according to Harris a 1% hike in corporate taxes reduces the underlying tax base over 3x more than a like hike in personal income taxes.

Alan Gelb, an economist at the Washington-based Center for Global Development, specializes in the impact of resource wealth on national economies. On January 20th he was in Ottawa for a press conference to present his report entitled <u>Should Canada Worry About a Resource Curse</u> for the University of Calgary's School of Public Policy (*many Canadian universities now seem to have one of these*). His overall message was that Canada needs to manage its politics so as to avoid *undue* dependence on resource revenues, and that the tendency for resource-rich countries to spend freely when resource prices are high should be resisted & savings amassed in good times as buffers against inevitable resource price shocks. Other than that, his was a good news, bad news story. The former because he says Canada has a well-rounded economy, capable government & educated work force which makes the ownership of resources on balance a benefit to its economy. And the latter because this benefit is being poorly managed, especially in Alberta where the government is running deficits in the midst of an "unparalleled resource boom"[2] while being doubly vulnerable since "the rent margins *on high-cost resources such as the oilsands* will be ever more volatile than prices" & the possibility of the oilsands becoming a "stranded asset" due to the delays in building pipelines is "quite a large risk." - *despite its $17BN "Sustainability" rainy day fund having all but melted away in just four years, the Alberta government maintains its budget will be in balance by next year while a well-informed outside analyst recently confided that he expects it to 'hit the (fiscal) wall' in two years (small wonder Alberta's Minister of Finance is said to be thinking of leaving politics).*

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Thursday January 30th, 2014

OBAMA-XI SUMMIT MEET PLANNED FOR MARCH (Nikkei Asia Review, Naoya Yoshino)

- The White House is seeking a meeting between the two during the late March Nuclear Security Summit in The Hague, Netherlands & will despatch John Kerry to Beijing next month to tee it up. Obama plans to seek Beijing's cooperation in solving the mounting problems in East Asia, incl. North Korea, & *in reducing* the friction with its neighbours prompted by its provocative actions in the East-, & South-, China Seas. And Xi is expected to want to talk about his idea of a "new model of major power relations" (*which he first raised last summer & was somewhat fleshed out in a speech by Foreign Minister Wang Yi at the Brookings Institution last September 24th as having three key features : cooperation rather than conflict, mutual respect & win-win cooperation*). Another subject would likely be Prime Minister Abe's late December visit (against Washington's advice) to the Yakusine Shrine that further chilled Tokyo's already cooling relationship with Beijing & Seoul.

The Obama Administration is concerned that, if the tensions in the region are allowed to continue festering, a serious confrontation between China & Japan could ensue (especially since the hatred between their two peoples is becoming more palpable & is being fueled by populist politicians).

DEEP CUTS IN FOOD STAMPS AVOIDED IN FARM BILL (BB, Alan Bjerga)

- On January 27th House & Senate negotiators agreed on a much-delayed farm bill with far less deep cuts to the food stamp program than House Republicans had sought. It will save US$24BN by cutting it by US$8BN (one-fifth of what House Republicans had sought) & ending some direct payment farm subsidy programs. In FY13 the food stamp program cost US$76.1BN, 12% of the US$650BN Americans spend on food each year, & last October it was used by 47.4MM people (*15.1% of the population*). The bill will also forbid issuing food stamps to lottery winners (*!!!!*) & restrict their use by college students.

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[2] Not entirely true given the double discount on the Western Canada Select crude oil price.

This is the third bill both Houses have compromised on recently, suggesting Congress is becoming less dysfunctional (attributed in part to House Speaker John Boehner regaining control over his caucus). This is seen as reason for hope that the debt limit issue will be less contentious, & the debate thereof less acrimonious, than hitherto feared; in fact Politico claims House Republicans are becoming resigned to having to pass a "clean" debt ceiling bill[3]*. The article mentions that almost half of all food stamps are spent at Wal-Mart; given it has sales of U$490BN, one-third of them outside the US, this implies one-eighth of its US sales are food stamp-generated. And to Canadian livestock producers' dismay the bill continues to require all meat products sold in the US to specify the country where the animal whose meat is in a package was born, raised & slaughtered.*

US SENATORS SLAM STUDY ON SYSTEMIC RISKS POSED BY ASSET MANAGERS
(Reuters, Emily Stephenson)

- *In 2010, after the 2008 financial crisis, Congress passed the 848-page Dodd Frank Act. It included a provision for a Financial Stability Oversight Council (FSOC) to 'identify risks to the financial system' & an Office of Financial Research (OFR) in the Treasury to 'improve the quality, transparency & accessibility of financial data, conduct & sponsor financial research, and promote best practices of risk management'.*
- Last September the OFR submitted a report the FSOC had asked for on the potential for systemic risk posed by *large* asset management firms like Blackrock (*AUM of US$4TR*) & Fidelity (*US$4.5TR*). It concluded they could indeed pose a threat to markets when they borrow to boost returns (*i.e. "leveraging", which had contributed to the financial crisis*) or simultaneously seek to crowd into (*or exit?*) the same asset class. But in a letter to Treasury Secretary Jack Lew dated January 24th, five Senators[4], one week before OFR Director Richard Berner was to testify before the Senate Banking Committee, slammed the report[5], saying that, while they support identifying financial firms posing a threat to markets, the report "mischaracterizes the asset management industry and the risks asset managers pose, makes speculative assertions with little or no empirical evidence and ... predicates claims on misused or faulty information ... We strongly urge the FSOC ... not to have any policy or regulation grounded on the information in the OFR study."
- A Treasury spokesman observed "The OFR consulted with FSOC member agencies and market participants, and ...was transparent about its data sources." The asset managers maintain they are not 'too big to fail' (*or 'too big to **allow to** fail?*)[6] & shouldn't be regulated like banks. And the SEC seeking feedback is seen by some as indicative of not agreeing with the report's findings, *although a more plausible reason may be its nose is out of joint for not having had more input in it, to the point where it may have sought to sabotage it (as suggested by a comment that 'the OFR had experienced difficulties gathering data'*).

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3 Which will disappoint Keystone XL proponents who have hoped that they would make their support conditional upon Obama approving it.

4 Democrats Claire McCaskill of Missouri & Thomas Carper of Delaware, and Republicans Mark Kirk of Illinois, Patrick Toomey of Pennsylvania & Jerry Moran of Kansas.

5 While it also said that it threatened the OFR's credibility, if this were to be the case, it would likely gladden the hearts of, rather than upset, those who put them up to writing this letter.

6 Which is, of course, utter tommy-rot, given their asset bases relative to JPMorgan's.

BlackRock & Fidelity should be categorized as 'too big to fail', if only because their asset bases are about twice that of the biggest US bank, JPMorgan. There is a further risk to the system from the like mindset of many asset managers having the potential for increasing market volatility. And finally, a firm like Fidelity manages mutual funds owned by millions of ordinary Americans; so its failure would not an option politically. But even a wee fraction of the management fees on their trillions in AUM buys a great deal of influence on Capitol Hill.

INDUSTRY AWAKENS TO THREAT OF CLIMATE CHANGE (NYT, Coral Davenport)

- In 2004 Coca Cola lost a lucrative license in India due to a serious water shortage; ever since it has *increasingly* embraced the idea climate change is an economically disruptive force. And the view is gaining momentum in US business circles that global warming will contribute to lower GDP growth, higher food- & commodity costs, supply chain problems & greater financial risks. In contrast the coal industry maintains policies to cut carbon emissions are more harmful than the impact of climate change; thus Roger Bezdek[7], in a coal lobby-sponsored study published recently, says "such policies will increase the cost of ... electricity ... Even the most conservative estimates peg the social benefit of carbon-based fuel as 50 times greater than its supposed social cost."[8] Meanwhile China & India continue to depend on cheap coal-fueled electricity to power their economies, and the EU has cut back its climate change-, & renewable energy-, commitments.
- On the other hand, at Davos all of one day was devoted to climate change. The American Economic Association's new President is a global expert on the economics of climate change. The World Bank has made climate change the focus of its mission. Nike has had supply chain disruptions from climate change-driven floods, grown concerned about shrinking water supplies affecting cotton production[9] & included the impact of climate change on water supplies in its SEC financial risk disclosure filings. Thomas Steyer[10], Michael Bloomberg & Henry (Hank) Paulson have commissioned a study to be entitled Risky Business to assess the impact of climate change by region & industry sector across the US. And while many Republicans oppose carbon taxes, *prominent* conservative economists endorse the idea, incl. Arthur Laffer, Reagan's economic adviser in the 80's, Harvard's Greg Mankiw, Mitt Romney's in 2012 &*, from 2003-2005 George Bush's*, & Douglas Holtz-Eakin, McCain's in 2008 (who concedes "there will be agriculture and economic effects - it's inescapable").

A US Foreign Service "brat", Davenport grew up in Korea, Japan & Greece. After journalistic stop-overs at the National Journal, the Congressional Quarterly, Politico, Massachusetts' Daily Hampshire Gazette & three years in Greece, she became the NYT's climate-and-energy reporter on December 1st of last year. On December 5th, in her first contribution her opening

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7 Head of MISI (Management Information Services Inc.) & a Ph.D. in Engineering & Physics

8 Go & tell that to Chinese parents who are sending their child to schools where he/she can do sports & spend his/her recesses inside huge plastic domes with air filtering systems, safe from the lung-damaging air outside.

9 It takes 2,700 litres of water to grow the cotton for one T-shirt & cotton irrigation accounts for 2.6% of all global water consumption.

10 See below under the Anti-Keystone ad item.

paragraph was "more than two dozen of the nation's biggest corporations[11]*, incl. the five major oil companies*[12][13]*, are planning their future growth on the expectation that the government will force them to pay a price for carbon pollution as a price to control global warming." In US politics, as in many aspects of human endeavour, "follow the money" is a useful concept; if so, this may help the traditional, business-friendly wing of the GOP to gain the upper hand over the anti-just-about-everything-including-climate-change Tea Party types (who, however, have a direct line into the US$100BN annual revenue deep pockets of the 'environmental Neanderthal/Nihilist Koch brothers).*

<u>ANTI-KEYSTONE AD REVEALS CANADA'S VULNERABILITY TO U.S. POLITICS</u>
(Postmedia News, Michael Den Tandt)

- The NextGen Group, funded by anti-oilsands, *social activist & California-based* billionaire Tom Steyer will run anti-oilpatch ads before & after Obama's State of the Union Address. Using stark imagery, crafty editing, a selective use of facts & a punchy, populist script[14]*,* they will explicitly & shamelessly accuse the Canadian government of being in league with Beijing to "sucker punch" America's heartland & twist facts to imply China, with help from Canada, is launching a nefarious quest to lay America low with "tar sands" skull duggery.
- For a couple of years already it has become increasingly evident that major new domestic oil supplies have made the Keystone less critically important as a bulwark of US national security. Obama has long been under pressure from his base, *possibly somewhat unfairly so*, for 'Selling out to The Man'*.* And Harper himself has helped to create the conditions under which such propaganda can work by seeking to stiff arm Obama *by saying 'We will not take No for an answer'?*[15] & no politician likes that. His government has time & again also failed to act on its promised greenhouse gas emission standards, thereby undermining its credibility. And the Natural Resources Minister branding environmentalists as "foreign radicals" was not an astute move either. The truly astonishing part of all this is that, while pipelines are at the heart of the Conservatives'

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11 Incl. American Electric Power, Conagra Foods, Delta Airlines, Duke Energy, Dupont, General Electric, Google, Microsoft, Walmart, Walt Disney, Wells Fargo,

12 ExxonMobil, Chevron, ConocoPhillips, BP & Shell.

13 ExxonMobil's inclusion is surprising. For during the eight year tenure of Chairman & CEO Rex Tillerson (who in 2008 survived a challenge by the Rockefeller family to split his two jobs & devote more resources to developing renewable energy sources) this Company has been at the forefront of those funding what many academics deem "pseudo-scientific" research seeking to debunk climate change & global warming and who, as recently as last year's ExxonMobil's Annual Meeting, was said to have posed the rhetorical question "What good is it to save the planet if humanity suffers."

14 I.e. modern day advertising techniques of the highest order. An elderly journalist friend of mine said not long ago that his father, also a journalist, had told him not long before his death that the biggest change in his life had been the transformation of advertising from an information-distributing phenomenon to a selling medium.

15 A line much softened by Foreign Minister John Baird during his recent visit to Washington when he was quoted as saying his government cared less about what answer it got on the Keystone than about getting it soon (in recognition of the inevitable?).

long-term strategic plan for Canada, that strategy now lies in near ruins because of their incompetence, domestically in dealing with aboriginals & diplomatically with Washington.

Politico's coverage noted the ad accused Keystone backers of treating Americans like "suckers" by saying it would help the US energy supply picture, while in reality many of its benefits would go to China, & that "Keystone means more profit for investors like China, more power for their economy and more carbon pollution for the world." (its reference to the Chinese boogeyman will tug at the heart strings of every red-blooded American, regardless of party affiliation, if any) - *Steyer was an early Hillary Clinton supporter but switched horses in mid-stream to become one of Obama's most prolific fund raisers. And in this critical mid-term election year his behind-the-scenes role in the (paper-thin) win of Terry McAuliffe last November in the Virginia gubernatorial race (which broke a three-decade-long tradition of Virginians electing governors from the party not occupying the White House) will likely be a factor in Obama's eventual Keystone decision.*

<u>WHY KERRY IS SCARY</u> (NYT, Thomas L. Friedman)

- He is testing the questions everyone has sought to avoid. Is it five minutes before-, or after-, midnight for the Israelis & Palestinians? Has Israel become so powerful that a symmetrical negotiation is impossible, especially since the Palestinians seem unwilling, or incapable, of mounting another intifada? Has the number of settlers grown so large-, & the Palestinians' rhetoric on the right to return become so imbedded in their psyche-, as to be immovable? Does all this add up to it being a fantasy to believe that both sides can make the huge concessions needed for a two-state solution?
- President Obama is letting Kerry test all of this. If this fails, this would open the door for laying out a framework for what they deem a fair & lasting deal. It will call for a phased Israeli withdrawal from the West Bank based on the 1967 lines, with the exception of certain settlement blocks, subject to territorial exchanges, for unprecedented security arrangements for the Jordan Valley, for a Palestinian capital in East Jerusalem in exchange for Palestinian recognition of Israel as the nation state for the Jewish people, and for no 'right of return'.
- Kerry expects, & hopes, both sides will accept this as the basis for negotiating a deal, even while declaring to have reservations about various aspects thereof. Both US & Israeli officials say Netanyahu clearly understands that some form of a two state solution is vital to Israel's integrity as a Jewish democratic state (he declared on January 28th that "I don't want a bi-national state. But we don't want a state that will attack us." But his political base does not want him to make a U-turn; so his coalition would collapse & he would lose a major part of his Likud Party, and would have to build a new political base from among the centrist parties. But his, & Israel's, alternatives to accepting this framework are limited to a) unilateral withdrawal, b) continuing to live with the morally corrosive-, *increasingly* globally isolating-, *& dangerous* permanent West Bank occupation *in a country where the birth rate favours the extremist elements*, or a 'one state for two peoples'.

The late Ariel Sharon, his arch enemy, showed him the way a few years back, albeit on a smaller scale, with his parting company with Likud & founding the Kadima Party.

<u>TURKEY RAISES RATES SHARPLY TO BOLSTER CURRENCY</u> (WSJ, Yeliz Candemir)

- *Given the recent turmoil in the market for its currency*, it had expected the Turkish central bank to raise its various 'administered' interest rates by two of three percent. But the outcome of an 'extraordinary policy meeting' on January 28th, described by some as a "shock & awe" move, was to raise its overnight lending rate from 7.75% to 12.00% & its late liquidity lending rate (for last minute borrowing by banks before the market closes) from 10.25% to 15.00%, and to more than double two other rates from 4.50% to 10.00% & from 3.50% to 8.00%. Not entirely surprising, the Turkish lira strengthened in the aftermath of this announcement (*although it would not be surprising either if the market upon reflection were to start looking upon this move as a panic reaction to unspecified, **really** serious problems).*

- This move came hours after a surprise rate hike in India, driven by concern about rising prices overriding the fact its economy is facing its slowest growth outlook in a decade.

Last fall when the lira hit a then record low 2.07 to the US dollar, the central bank governor predicted it would be back to the 1.97 level by yearend while at last report the rate was 2.24. While the Fed's tapering hasn't had much effect in the US, the same cannot be said about the emerging markets, which makes one wonder about its effect on global GDP growth this year.

<u>BANKING REFORM BID CONTENTIOUS</u> (John O'Donnell, Reuters)

- *As in the US,* since the Lehman debacle in 2008 Europe's "too-big-to-fail" banks have only gotten bigger. On January 29th the EC *finally* unveiled a long-awaited draft plan to isolate high-risk trading at its big banks. Rather than splitting up the banks, as originally talked about, it now merely proposes a ban on "proprietary trading". A spokesperson for the German Finance Ministry deemed it 'generally positive' & the Brits were OK with it, saying it was in line with its own reforms. But elsewhere the reaction was negative. Austrian law maker Hannes Swoboda called it "too little, too late", Germany's Green Party MEP Sven Giegold said it was too bureaucratic & ineffective with "loads of exceptions", & critics generally say it doesn't address the *unduly* large size of the big banks. But it really provoked the French, with not just its bank lobby but its central bank governor attacking the plan for giving an undue advantage to US banks in London that would be exempt from its rules.

The French line seems at odds with the Brits saying that it is "in line with its own reforms."