

According to JPMorgan next week's important news includes the minutes of the July 29<sup>th</sup>/30<sup>th</sup> FOMC meeting & those of the August 7<sup>th</sup> meeting of the Bank of England's Monetary Policy Committee (which may, for the first time in a long time, see less than total unanimity), flash PMIs for Europe, China & the US, and feedback from the central bankers' annual clambake in Jackson Hole, Wyo. hosted by the Kansas Fed, with this year's theme being Re-Evaluating Labor Market Dynamics & its focus on job creation & the amount of slack in the US economy, *both critical to the debate on how much scope remains for an "accommodative" monetary policy*<sup>1</sup> - *while job growth has been decent (200,000+/month), July retail sales were unexpectedly flat.*

The big American banks' modus operandi has changed. With regulators urging "prudence", & the Fed providing an all but risk-free way of making money by buying government securities, they have de-emphasized business lending. And the business lending they have engaged in has focused on their 'safest', big corporate<sup>2</sup> clients, while those they have ignored in the process, small-to-medium sized businesses, have historically been the drivers of job growth.

According to Business Insider last week high yield bond mutual fund experienced a US\$7.1BN outflow, the most ever & the largest weekly outflow since the US\$4.6BN last year in the week after Bernanke's 'tapering speech'. Goldman Sachs' Charles Himmelberg called this a "HY (High Yield) flowmageddon, a 6-sigma (*standard deviation*) event", & Business Insider's Andy Kierrsz equated it with flipping a coin 29 times & each time getting the same result.

Despite all the hype about the US aerial assaults on the Islamic State forces in Iraq<sup>3 4</sup>, it's worth remembering that in asymmetrical warfare air power has proven to be of limited use, liable to drive the bad guys underground to blend in with, & generate sympathy among, the hoi polloi<sup>5 6</sup>, & counter-productive in the battle for the "hearts & minds." And in this instance there is also an

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<sup>1</sup> While the June JOLT (Job Openings and Labor Turnover) report (known to be close to Yellen's heart) suggested slack in the labour market is diminishing, confirming anecdotal reports employers have difficulty finding qualified workers, this does not yet seem to have reached the point of them offering higher pay to poach workers from others (since they, like Yellen, believe this problem will be solved by a reversal of the 15-year-long decline in the worker participation rate?).

<sup>2</sup> That they, more often than not, have used the proceeds to buy back their own shares, an activity that, while boosting share prices, is of little, if any, **real** economic value.

<sup>3</sup> That the Pentagon says has slowed them down but not weakened.

<sup>4</sup> That now may pose another threat to the Baghdad regime because they control large parts of the five provinces that account for 40% of the country's wheat production (which at the best of times only produce about half the country's needs).

<sup>5</sup> As Chairman Mao said "Guerrillas must move among the people as fish swim in the sea."

<sup>6</sup> Thus when, in 1941, the Germans first started rounding up Dutch Jews for 'transport' East, there was a (brief) general strike with one anonymous Amsterdam street car conductor immortalizing himself by saying "those g.d., f#\$%^& Germans should keep their hands off our g.d, f#\$%^& Jews" - this in a society nowhere near as tribalized, feeling as marginalized & historically as blood feudal as the Arab one.

asymmetry between the opposing forces, with Islamic State fighters happy to die & go to paradise while their opponents aspire, at the end of the day, to go back, safe & sound, to their families.

Daniel H. Rosen is an expert on China, an adjunct professor at Columbia, a Visiting Fellow at the Washington-based Peterson Institute for International Economics, a member of the Council on Foreign Relations & a Board Member of the National Committee on United States-China Relations. In 2003 he founded the New York-based advisory Rhodium Group (RHG) which recently opined that China Prime Minister Li's economic reform program is critical to the country's future since, if it succeeds it will lay the foundation for sustainable 6% annual GDP growth by 2020 while if it fails it will limit it to 1%-3% annually, a rate deemed incompatible with social stability (views, it says, that are shared by senior Chinese officials) - *a recent IMF report expressed a not dissimilar view. For, after noting that total credit growth in China in the past five years has amounted to 73% of GDP, it says this ranks it among the five most explosive cases of credit expansion in the post-WW II era, the other four of which all culminated in banking crises & sharp recessions within three years. And the Chief of its China mission concluded that, while "Our assessment ... is that the near term risk of a hard landing ... is low ... By the same token we need to say that ... unless reforms are implemented (quickly) the risk of a hard landing will increase..." (recently the earlier zeal for reform seems to have abated in Beijing while it may have added fuel to the fire with another stimulus package that, while "targeted", may increase the probability of a hard landing by favouring low-productivity state-, rather than higher-productivity privately-, owned entities).*

China's 10MM Uighurs, most of whom reside in the Xinjiang Uighur Autonomous Region in the country's far Northwest, are among the largest of its 56 recognized minorities. They are Muslims whom Beijing has long tried in vain to assimilate, in part by flooding the region with Han Chinese (which has created widespread resentment). Starting late last year there have been a series of terrorist events across China, attributed by the authorities to Uighur nationalists; so in May the Xinjiang Party Chief launched a one-year campaign to "safeguard stability and resolutely prevent malignant violence and terrorist attacks", during the first month of which Beijing arrested 380 individuals & executed 13, and 32 "violent terrorist" gangs were broken up & 264 devices 'capable of detonating 3.15 tons of explosives' confiscated. Next he forbade teachers, students & civil servants to observe their Ramadan obligations, incl. the daytime fast, as a result of which on July 28<sup>th</sup>, the day Ramadan ended, a mob armed with knives & axes attacked a police station & government buildings in the region's Shache county, killing 37 people & injuring 13 more (most of them Han Chinese), while the police shot & killed 59 of the attackers, arrested 215 more & found banners advocating 'Holy War'. And three days later Juma Tahir, an Uighur imam but a staunch supporter of the CCP, was stabbed to death outside his mosque - *while hitherto the Uighur nationalists sought to dissuade more Han Chinese from coming to the region, & those already there to leave, their strategy now seems to have shifted to provoking Beijing into overreacting, so as to boost local support for their cause (with the situation now having gotten sufficiently out of hand that Beijing will oblige them with, according to some observers, little chance of success).*

Japan's Second Quarter GDP growth came in at a seemingly disastrous -6.8% QoQ annualized rate, way down from the First Quarter's +5.9% (the most in over two years). But this was actually slightly better than expected. And the explanation lies in the long-overdue introduction, on April 1<sup>st</sup>, of a sales tax hike from 5% to 8% which prompted anticipatory consumer spending in the First-, that 'borrowed' from what would otherwise have occurred in the Second-, Quarter.

But what's more worrisome from a global economic outlook perspective is that the latest numbers from Europe have been 'weak, to say the least. In Germany the latest ZEW numbers

of people's assessment of the current-, & near future-, situation fell out of bed and Second Quarter GDP growth was actually negative QoQ, & that of France, that had been expected to come in at 0.5%, was actually flat, both in part collateral damage from events in Ukraine & the Russian sanctions). And the yield on two-year German 'Bunds' is now negative, suggesting that investors sooner **pay** the government to keep their money safe than '**risk**' it by keeping it free of charge on deposit in a bank. And yet at the same time yield-hungry institutional investors have been snapping up unprecedented amounts of 'junk bonds' from European companies with less-than-investment-grade credit ratings, many of them from the PIIGS countries; thus in the year ended July 31<sup>st</sup> they sold US\$131BN of such bonds (up 70% YoY, & 3x the amount sold in the twelve months to July 31<sup>st</sup>, 2012)<sup>7</sup>, despite the fact that their average spread over similar maturity German Bunds has narrowed in by 40% to 382 bps.

London's Oxford Street is one of Europe's premier shopping venues. So it didn't go unnoticed when, on August 13<sup>th</sup>, young Muslims started handing out leaflets there *indirectly* supporting ISIS by declaring the Caliphate had arrived, and Muslims had a duty to pledge allegiance to the Caliph & to move to where he rules (prompting one *Muslim* counterterrorism expert to note "Gaza is making a lot of Muslims angry and frustrated") - *the perpetrators were students from Luton Town, a hotbed of radical Islam, and many people would be happy if they were to do what they preached, i.e. relocate to the ISIS-controlled parts of Syria & Iraq (contrary to the old saying to "keep your friends close and your enemies closer.")*

On August 7<sup>th</sup> Russia's central bank announced that in a meeting with representatives of the RBI (Reserve Bank of India) the use of their national currencies in mutual *trade* settlements had been discussed & that "Given the urgency of the issue and the interest of the commercial structures of the two countries, the meeting had decided to establish a working group for the use of national currencies in mutual settlements" - *another step in a growing global campaign, spearheaded by the BRIC nations, to reduce the role of the US dollar as the currency of denomination of-, & that of the Federal Reserve as the world's lead central bank in-, the international monetary system.*

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**Thursday August 14<sup>th</sup>, 2014**

**MIDDLE EAST CHANGES MAY NECESSITATE NEW US POLICIES AND ALLIES**  
**(Straight.com, Gwynne Dyer)**

- The declaration of the Islamic State *cum Caliphate* has major implications not just for nearby countries but also for major ones elsewhere with minority Muslim populations, ranging from Britain & China<sup>8</sup> to Russia & the US, all of whom want radical Islam contained, if not stopped. So both the Iraqi & Syrian regimes will be made to survive, the Kurds will get more & better weapons (even if this makes Baghdad unhappy), Egypt's General Sisi will be supported to the point of being encouraged to take on the Libyan rebels, the US-Iran rapprochement will continue (no matter what Israel says) & the latter will feel more pressure to ease its stance vis a vis the Palestinians in the West Bank,

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<sup>7</sup> Whereas in the US junk bond market the volume had been only US\$150BN, down slightly from the year earlier period & up only about 10% from the year ended on July 31<sup>st</sup>, 2012.

<sup>8</sup> Thus on August 8<sup>th</sup> Beijing announced, after President Obama had authorized airstrikes against ISIS in Iraq, that it had an "open attitude" to actions contributing to security there.

Sunni Hamas in Gaza & Shiite Hezbollah in Lebanon, as well as its settlement policy in the West Bank, & to get on with moving towards a two-state solution.

- Containing ISIS from the North will be relatively easy since both Turkey & Iran are strong states with little to gain from supporting it. But doing so in the South will be a different matter; for the Wahabbi brand of Sunni Islam is all but the state religion in Saudi Arabia & *has long been the fairy godmother & financial backer of Sunni Muslim extremism*. So the Saudi Royals will have to fish or cut bait in the knowledge that the extremists won't show them much gratitude for their past support & they are no longer as critically important to US interests as they once were.

*So the only places where the Arab Spring will survive in the short run may be Tunisia &, possibly, Morocco; elsewhere democracy will be pushed back into the closet, and armed conflict and/or repression will, at least for the time being, be the order of the day.*

### **RBI GOVERNOR RAGHURAM RAJAN WARNS OF ANOTHER MARKET CRASH** **(Times of India)**

- He recently told the London-based Central Banking Journal among others “a number of macro-economists have not fully learned the lessons of the great financial crisis. ... They still do not pay enough attention ... to the financial sector ... We are taking a greater chance of having another crash at a time when the world is less capable of bearing the cost<sup>9</sup>. Investors say ‘we will stay with the trade because central banks are willing to provide the easy money and I can foresee ... easy money continuing into the foreseeable future’. They put the trades on even though they know what will happen as everyone attempts to exit positions at the same time ... The risks build up until, wham, it hits you ...*central banks* may be ... creating a situation where there will be a discontinuous movement in the financial sector ... True, it may not happen if we can find a way to unwind everything steadily. But it is a big hope and a prayer ... We are back to the 1930's ... Back then, it was competitive devaluation, but competitive easing could lead to competitive devaluation. If there were no consequences to competitive easing, fine; but there are consequences.”
- He has been calling for some time for more *monetary* policy coordination among central banks on the grounds that the developed world's central banks' policies may suit the instigators but not be convenient for other central banks, and welcomed the IMF's recent announcement it will start “examining” the monetary policies of major central banks to check their *system-wide* net benefits. And, while conceding “I have no doubts that countries will still do what is in their best interests”, he maintains that “over time we need a little more effort looking at the global interest. My sense is that once the debate is engaged, we will figure out a way to move in that direction.”

*While in so doing he is ‘talking his own book’, there is little doubt that, with an undergraduate degree in electrical engineering, a Ph.D. in Management from MIT, tenure at the University of Chicago Business School, a stint as the IMF’s Chief Economist & membership in the Washington-based Group of 30 (financial illuminati) once headed by Paul Volcker & now by Jean-Claude Trichet, former Head of the Bank of France & the ECB, he, like Mark Carney at the Bank of England, is representative of a new breed of more ‘real world-rooted’ & less ‘ivory tower-based’ central bankers, and at age 51 is a ‘comer’ in the global central banking cum*

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<sup>9</sup> Although on August 14<sup>th</sup> he said in Mumbai that the Indian economy was in a much better position now to handle external shocks than last year when the rupee hit a record low.

*financial community in the period ahead (especially if Prime Minister Modi were to succeed in getting the Indian economy back on its fast growth track of yesteryear - which, so far, he has been criticized for having given little sign of).*

**JANET YELLEN DETERMINED TO AVOID 'NIGHTMARE SCENARIO'**  
**(Business Insider, Howard Schneider)**

- Interviews with current & former Fed officials indicate she doesn't want to raise interest rates too early & risk hurting the 'fragile' US economy (or to have to "backtrack", i.e. raise rates only then to have to cut them again) & to be confident that, if the outcome were higher-than-targeted level of inflation, it could be managed - *there is a body of empirical evidence in the history of Latin America, & that of the United States itself three decades ago, that controlling inflation, once it gains a foothold, is easier said than done.*

*And there may be an element of hubris in the Fed's former Chief Economist's comment that "The Fed knows how to control inflation if it is moving", while the impact of another downturn would be "more uncertain and hard to counter".*

**PROPOSAL THREATENS TO AGGRAVATE SHORTAGE OF RAIL CARS TO MOVE OIL**  
**(WSJ, Bob Tita)**

- The Obama Administration is proposing new regulations to end the use, by 2018, of the DOT 111-class tank cars *that have a tendency to rupture when a train derails* in hauling flammable liquids (incl. Bakken oil & ethanol<sup>10</sup>). This may aggravate the already existing shortage of tank cars that haul such cargoes & make it more costly to do so. With the *three or four* American rail car manufacturers having an aggregate annual manufacturing capacity of 35,000 tank cars, & there already is a 52,589 car backlog of cars on order, the industry may have difficulty meeting the time frame envisaged by the regulators. And the government has been accused of low balling the estimated cost of retrofitting the 30,000 cars used to haul ethanol.

*Since about 100,000 DOT 111 tank cars are to be replaced, the 2018 time frame doesn't seem all that unreasonable. But critics are driven by several other considerations. Most tank cars are not owned by the railways but by investor-owned lessor companies concerned about fierce price competition for non-flammable cargoes that a huge surplus of DOT 111 tank cars will engender. The proposed new specifications mean that even some cars newer than the DOT 111 type must be refitted. Refitted & new cars will be only 17-21% less likely to rupture in a derailment. And the new regulations will hike the cars' tare weight & hence reduce their load capacity.*

**NEW LEAKER DISCLOSING US SECRETS (CNN, Evan Perez)**

- On August 5<sup>th</sup> [The Intercept](#)<sup>11</sup> published details of the US National Counter-Terrorism Center data bases of names of known & suspected terrorists from a document dated August 2013, i.e. after Snowden had fled to Russia.

<sup>10</sup> In 2013 US railroads moved 300,000 carloads of ethanol & 408,000 of crude oil.

<sup>11</sup> The news site launched by Glenn Greenwald, the American lawyer & Guardian columnist who published Edward Snowden's leaks & who in an interview on CNN last February said "it's fair to say that there are *other* people ... inside the government who've seen extreme wrongs ... (and) are inspired by Edward Snowden."

*The only good thing was that the document was only classified “SECRET -NOFORN”<sup>12</sup> while the lion’s share of the 1.7MM documents purloined by Snowden was classified “TOP SECRET”.*

### **ERDOGAN’S VICTORY IN TURKEY COMES AT A HEAVY PRICE (Haaretz, Louis Fishman)**

- After 11 years as Prime Minister, Recep Tayyip Erdogan is now the first-ever directly-elected President of the Republic of Turkey in its nearly 100-year history. He sees this as a victory for ‘the people’ over ‘the elites’ that have run the country since Kemal Pasha Atatürk’s post-WW I days, and he & his followers as an opportunity to create a new Turkey by the time its centenary rolls around in 2023. But his party doesn’t have a majority in Parliament, he was elected with just 52% voter support in a light turnout & his post is largely ceremonial (even though he will try & keep control by appointing a ‘tame’ Prime Minister) unless he can push through constitutional changes, for which his party needs to gain an absolute majority in the 2015 parliamentary elections. And his campaign for the Presidency was negative in nature, with him calling his various opponents & detractors derogatory & inflammatory names which, while it went over well with Turkey’s Sunni majority, polarized the country & alienated its minorities, the support of some of whom he needs if his party is to get a majority in Parliament in 2015.

*While the writer, a professor at the City University of New York who has lived in the US, Israel & Turkey, may well be right, Erdogan has proven to be a wily politician whose ability to pull the chestnuts out of the fire in the 2015 election should not be underestimated, despite the fact that on his watch Turkey’s influence in regional politics has declined significantly.*

### **FOREIGN MINISTER SNUBS US PUSH FOR SEA MORATORIUM (Global Times<sup>13</sup>)**

- Over the August 8<sup>th</sup> weekend, at the Fourth East Asia Summit Foreign Minister’s Meeting (in Myanmar), China’s Wang Yi rebuffed the US idea of a moratorium on “provocative actions” in the South China Sea & ‘clarified’ Beijing’s “unshakeable” position on the issue by saying it will listen to all ‘well-intentioned’ suggestions provided they are ‘objective, impartial & constructive’, even though such suggestions are made unnecessary by the Declaration on the Code of Conduct of Parties in the South China Sea (COC)<sup>14</sup> (this came after Wang had, in an earlier meeting with John Kerry, told him the situation in the South China Sea was “stable” & there was no problem with the freedom of navigation).

*Meanwhile, Adm. Harry Harris, Commander of the US Pacific Fleet, lived up to his reputation for being “plain-spoken” when he told The Australian that, given China’s destabilizing & provocative conduct there, the South China Sea was “an accident waiting to happen” but that he was confident the US Navy could deal with any Chinese missile threat resulting thereof. And Wang, in a meeting at the Summit with his Japanese counterpart, Fumio Kishida, called on Japan to “make practical efforts to overcome existing political obstacles between the two sides”, while former Japanese PM Yasuo Fukuda (who supposedly is well plugged-in with the Chinese leadership), during a July 27-29 visit to China to convey Prime Minister Abe’s eagerness for a*

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<sup>12</sup> Which means it cannot be shared with foreign nationals.

<sup>13</sup> The English language-only affiliate of the China Daily

<sup>14</sup> Agreed to (reluctantly?), at Beijing’s urging, by the ASEAN countries in September 2013.

*summit with President Xi, apparently had agreed that the two nations should patch up things, and promote greater cooperation in developing natural resources & environmental technologies.*

## **PUTIN IN PUSH TO DOUSE NEW DISCORD ON RUSSIA'S DOOR STEP**

**(BB, Zulfugar Agayev)**

- In 1991, after the collapse of the Soviet Union, Armenia seized the Azerbaijani district of Nagorno-Karabakh (*most of whose residents were Armenian*), prompting an armed conflict in which 30,000 people were killed that ended with a Moscow-brokered cease-fire in 1994. Since then Azerbaijan has forged close links with Israel & Turkey, and in the past decade increased its defense budget 27-fold to a level greater than the entire budget of Armenia<sup>15</sup> (which depends on Russian troops to defend its borders).
- Since July 26th there have been the “deadliest clashes in 20 years” (*in part because of both sides’ first-ever use of weaponry other than small arms*) in which 24 soldiers, *two-thirds of them Azeris*, have been killed. This prompted Putin to invite the leaders of the two countries to his summer place in Sochi to try & restore peace in the region *since the last thing he needs right now is unrest on his Southern border*, with two days of talks producing little more than an agreement to keep talking.
- According to Thomas De Waal of the Carnegie Endowment for International Peace there is “No way they (*i.e. Putin c.s.*) need a war in Karabakh ... Russia has a strong incentive to preventing a new conflict as it would cause massive instability on its Southern tier” (& *Russia is treaty-bound to defend Armenia militarily*). And in the view of Matthew Bryza, the US Ambassador to Azerbaijan in 2010-2011, any serious outbreak of hostilities between the two countries will further complicate Putin’s position at home that, he says, “has already been *negatively* affected by the role he’s been playing in Ukraine”.

*This situation is like a Russian “matryoshka’ (i.e. nesting) doll. Since 1991 the Azeri component of Nagorno-Karabakh’s population has been reduced from 25% to virtually zero. The Armenians are (Orthodox) Christians (& hence, nominally at least, Putin soulmates) while the Azeris are Muslims (mostly of the Shia persuasion, as in neighbouring Iran). Armenia (cut off by Georgia from Russian territory) relies on the Russian military to defend its borders with Iran & (arch enemy) Turkey, while Azerbaijan has been making overtures to NATO. While during the Soviet era Azerbaijan was its third-most important oil-producing region, today it is also the only route for Caspian Sea oil<sup>16</sup> to reach world markets (via the 1,768 km., 1MM bbl/d Baku-Tbilisi-Ceyhan (BTC)-, and/or the 833 km, 145,000 bbl/d Baku-Supsa-, pipelines<sup>17</sup>) without having to cross Russian soil. More recently Azerbaijan has begun to aggressively develop its natural gas reserves & last December BP, long the major player in its oil sector, led a consortium that secured a US\$45BN contract for piping natural gas to Europe starting about four years hence (that should help reduce Europe’s dependence on Russian gas).*

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<sup>15</sup> As it could well afford to, since its GDP in the past decades has grown at annual rates as high as 30+%, a significant multiple of that of Armenia’s GDP

<sup>16</sup> The first Azeri oil well was drilled in 1847, 12 years before the first one in Pennsylvania.

<sup>17</sup> Baku is the Azeri capital & located on the Caspian Sea, Tbilisi the capital of Georgia, Ceyhan a port on the Eastern Mediterranean in Southeastern Turkey, and Supsa a Georgian port on the Black Sea.

## **PUTIN'S UKRANIAN GAMBLE HASTENS EXODUS OF RUSSIAN MONEY AND TALENT** **(Reuters, Guy Faulconbridge)**

- While its oil & gas is still flowing West, even as its US\$2TR economy is threatened with isolation, so are its capital & talent. Whereas Russia's Economy Ministry is forecasting US\$100BN in capital outflows for the year (up from US\$61BN last year), the Moscow Higher School of Economics expects them to be more like US\$130BN to US\$150BN, President Obama said on August 6<sup>th</sup> that as much as US\$200BN may already have left this year & ECB President Mario Draghi has set the number at US\$214BN. And Russian statistics show that while in each of 2010 & 2011 about 35,000 Russians left, in 2012, *i.e. after Putin regained the Presidency*, their number rose to 122,751 & in 2013 further to 186,382 (and even the latter numbers may understate reality since people are known to have left physically while formally remaining registered as Russian residents), with Lev Gudkov, head of the Levada Centre, an independent polling organization, saying "we are losing the most educated, most active and most entrepreneurial people."

*While Gazprom (in which Putin personally is believed to have a 4½% stake) has asked the government for a US\$40BN loan, part of this may be a function of its need to build the US\$18BN pipeline to meet its Chinese sales target under the deal Putin signed earlier this year. On the other hand, it also just reported that its First Half profits were down 38% & that it expects to produce 5% less gas this year than in 2013. There appear to be two reasons for the latter : Ukraine earlier this year upped its gas purchases by 44% to stock up before Gazprom would cut it off once again in their perennial payment dispute (which it did in June) &, in response to Putin's activities in Ukraine, the EU has suspended work on the 2,500 km South Stream Gas pipeline that would bypass Ukraine by routing its gas exports to Europe via the Black Sea & Bulgaria. Small wonder Gazprom shares trade at 2.7x earnings.*