In 1994 Ian Bremmer graduated from Stanford with a Ph.D. in Political Science. Four years later, with US$25,000, he founded the Eurasia Group, that now has 150 employees & offices all over, & is deemed the world's pre-eminent global political risk research & consulting firm. The basic thesis of his just-out book Superpower is that since the end of the Cold War the US hasn't had a defined foreign policy strategy but has been risk-averse & reactive*, and made up 'on the fly'*. And he believes that, going forward, the US has three strategic foreign policy options :

- **Indispensable America** (go with the heart) - Americans care about making-, & will work (& *be willing to pay for?*) to make, the world safer, if only since it will make America safer &, if America doesn't make like the world's policeman, it will be a more dangerous world;
- **Moneyball America** (go with the wallet) - run the place like a company, calculate what America is spending its money on, and minimize the costs & maximize benefits thereof;
- **Independent America** (go with the head) - American values matter but the best way to promote them is by investing in, & focusing, on America rather than policing the world (*i.e. crypto isolationism?).*

For two decades Allianz-owned, Newport Beach, Cal.-based PIMCO prided itself on managing, among others, the world's largest bond fund, the Total Return Fund, and its manager, & the firm's founder (in 1971), 70-year-old billionaire Bill, was a legendary figure in the US bond market (although in recent years increasingly in his own mind since he made a number of sub-optimal calls that led to large withdrawals of clients' money that more than halved the fund's AUM to about US$145BN). But last September Gross quit the firm, before he was dismissed, & joined Denver, Colo.-based Janus Capital, a firm with AUM of just US$280BN to manage a four months'-old bond fund with AUM of just US$13MM. Since then PIMCO's Total Return Fund as continued to hemorrhage assets until last month its AUM were just US$110BN & it was replaced as the world's largest bond fund by Vanguard's US$117BN Total Bond Market Index Fund (that as the name indicates is not 'actively-managed').

Last January 15th the Chinese military's Liberation Army Daily published the names of 16 senior officers that had been sacked for corruption, on March 2nd it released the names of 14 more, & on April 26 those of another three. This means that of the 100+ officials at the ministerial-, or equivalent-, level sacked since President Xi Jinping launched his anti-corruption in 2013, the PLA, in just the first 100 days of this year had accounted for almost one-third (*as a result of his drive to 'make it more combat-ready'). It also seems to demonstrate Xi's growing power.*

A recent visitor to Europe made three interesting observations. The strength of the Swiss franc since its central bank relinquished its 'peg' to the Euro last January is starting to have a negative effect on its economy (in part by undermining the country's appeal as a tourism destination), as witnessed by the soaring sales of lower-priced wines. Secondly, a plate of spaghetti that costs 11 Euros in Nice, costs nearly 3x that in Zurich. And finally the Middle East arms race seems to be benefitting disproportionately benefitting European (especially French)-, rather than American-, armament firms (*& the same trend may well evolve if a nuclear deal with Iran is reached & its market is cracked open to imports from the West, as was the case in Iraq when its oil industry was opened up to foreign firms).*

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LOW RATES HAVE CAUSED THE CRISIS - THEY ARE NOT THE SOLUTION TO IT
(The Independent, Satyajit Das)

- Central bank *QE* policies stabilized conditions (*in the global economy after the 2008 near financial meltdown*) but didn't restore growth or create enough inflation to solve the world's debt problems; for, while the premise *underlying QE* was that expanding the money supply would create inflation, as the money supply was boosted money velocity slowed, offsetting the *inflationary* effect of the higher money flows. And, while inflation also requires a demand/supply imbalance, most developed countries had an "output gap" (the amount by which their economies' potential to produce exceeds demand) of between 2% & 8%[1], resulting in a lack of *corporate* pricing power that reduced the inflation *potential.*
- But while these policies were ineffective in achieving in their targeted outcome, they have had toxic side effects. They have left countries with large, & growing, levels of sovereign debt that will restrict their ability to respond to new crises. They have distorted normal economic activity; at least according to Citigroup's Equity Strategist Robert Buckland they have actually reduced employment & economic activity. They have encouraged a shift from bonds to equities &, as investors looked for income, forced companies to raise dividends, shedding workers & cutting investment to free up *the necessary* cash. They have cut retirees' incomes, thereby decreasing demand, & boosted the pension funds' unfunded liabilities, retarding growth as pension fund sponsors had to divert earnings to meet these future liabilities. And they have allowed the continued servicing of loans that will never be repaid but that banks cannot afford to write off, thereby interfering with the process of creative destruction & resource re-allocation that an economy needs to reach its potential.
- Low rates have distorted investment, encouraging undue risk-taking in search of higher returns; so risk premiums have fallen to uneconomic/*(unrealistic?*) levels for all security classes. This has been compounded by the high leverage in financial institutions' balance sheets : while the largest five UK banks are among the best-capitalized in the world, *even* their leverage (which may be understated[2]) ranges from 20x to 35x (so a 3%-5% drop in the value of their assets would render them insolvent). And the developed countries' monetary policies have adversely affected emerging economies by encouraging investors to invest in their markets in search of better returns, resulting in capital flows that created major problems for their economies (which have been key drivers of the global recovery).

As to the last point, the capital flows involved are mostly of a short-term "hot money"-, not a longer-term "patient"-, nature, & hence potentially destabilizing; for they can be 'here today & gone tomorrow'. [The writer is Calcutta-born & Australia-educated. He worked for Citigroup & Merill Lynch for a decade ended in 1987, during the early years of the derivatives era, before it became the domain of pointy-headed individuals with Ph.Ds in mathematics of finance, & still is a consultant on derivatives to financial institutions. And he has written several well-received books on the subject of derivatives for both professional-, & layman-, audiences, one of which, the 2006 <u>Knowns and Unknowns in the Dazzling World of Derivatives</u>, was described as the Financial Times as "Fascinating reading ... explaining not the high-minded theory behind the business ...but the sometimes sordid reality of the industry."

<u>WALL STREET IS BACK, ALMOST AS BIG AS EVER</u> (NYT, Neil Irwin)

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1 More importantly, what was, & remains, the size of China's output gap?

2 In part at least due to their derivatives' exposure?

- Several years after the crisis that shook Wall Street to its core, it has largely recovered. The vacancy rate in Lower Manhattan's Brookfield Place (once known, *pompously*, as the World Financial Centre) that had soared to 41% after Merill Lynch consolidated its operations with BankAmerica's in Midtown, is back to 5%. Last year its M&A business generated more profit than before the crisis. Employment on Wall Street is back to its 2007 level (as is the gap between their-, & everyone else's[3]-, compensation) &.the financial sector's profits are as large as a share of GDP as they were a decade ago (& over twice the average of the last seven decades of the last century). And after having them linger for five years at the US$70,000 level, major Wall Street banks this spring raised their base salary for new college graduates to US$85,000.
- But all is not well. New regulations & huge legal settlements have caused firms to become smaller & less profitable, and *really* excessive executive pay packages are less common. Last week the IMF released a report saying that the financial sector in several countries, incl. the US, is too large & there is a growing body of research suggesting that an unduly large financial sector may actually crimp growth by draining talented workers from the rest of the economy & by leading to boom-and-bust cycles. Thus Stephen Ceccheti, an economist at Brandeis International Business School, who has studied the relationship between the size of a country's financial sector & its economic performance, says that a very large financial sector tends to weaken productivity growth, research by New York University's Thomas Philippon concluded that the US financial sector has actually become less effective at channeling capital towards productive uses, & Luigi Zingales of the University of Chicago Booth School of Business told the American Finance Association in his presidential address this year that "there is no theoretical reason or empirical evidence to support the notion that all the growth of the financial sector in the last 40 years[4] has been beneficial to society."
- This may even become an issue that cuts along ideological lines in the 2016 election; for populists on both the left & right argue that finance is too big & powerful, and more legislation is needed to further pin back its ears; thus Sen, Elizabeth Warren (D.-Mass) & Sen. David Vitter (R.-La.) have floated a proposal to make bank bailouts less likely (with financial lobbyists & their (*funding-dependent?)* allies in Congress claiming that the regulations already adopted are too burdensome & an obstacle to growth).

Back in 2010 already, Goldman CEO Lloyd Blankfein, after having made a testimonial statement on the financial crisis to a Congressional Committee, under questioning conceded that not all financial market activity his firm engaged in was of 'real economic value' (historically the sole 'value-added function of banks was 'financial intermediation' – the bringing together of those having-, & those needing-, money to invest in ways that made the real economy tick; but today the tail is wagging the dog & the 'medium has become the message, with much of the Big Bank's profits being generated by trading for trading's sake (although to the somewhat limited to

[3] While the average pay per full-time worker in the industry was 2.2x that of the average American worker during the 70 years ended in 1999, that then almost doubled to 4.2x by 2007 after which it declined although by 2013 it had recovered to 3.6x, and likely has risen further since.

[4] It is interesting he picked this time framed; for the 1970's featured two financial 'breakthroughs' that changed the Western financial framework dramatically. One was "dis-intermediation", the process that vastly reduced the significance of the commercial banks as the key intermediary conduit between users & suppliers of funds by having the former issue securities directly to investors. And the other was the discovery by the French treasury that it could lower its overall borrowing costs by borrowing 'fixed' & 'swapping' the proceeds into 'floating', rather than by issuing floating rate debt (i.e. Treasury Bills in its own name (which ushered in the derivatives era).

which the "Volcker Rule", that sought to stop banks from operating in an unduly speculative manne, has been enacted the bloom has gone off that particular rose).

<u>WHEN THE LIGHTS GO OUT</u> (Quilter Cheviot Investment Management, David Miller)

- The price & availability of energy matters a lot, but it is only when the lights go out, or when it becomes painful to put fuel in our car, that most of us take notice. At the moment we are in a period of significant change. Aided by subsidies, alternate sources of energy are growing in importance[5] & the Saudis have concluded that cutting production when supply exceeds demand to support the oil price, *as they did in the past*, *just* encouraged high cost producers & enabled the alternate energy industry to gain market share at their expense. And after a long period of QE it is easy to make the sloppy assumption that (*bond?*) markets will always be liquid (the financial equivalent of expecting the lights to go on when you flick the switch *or, more importantly perhaps, of expecting water to come out of the faucet when you turn it*), while history suggests that occasionally the lights don't come on when the switch is flicked on (*as was the case in the financial markets during the immediate post-Lehman collapse era when liquidity in some markets all but totally dried* up). This illiquidity risk is underpriced.

In March 2014 the author, a London-based money manager, was named the 'Best Industry Commentator' at the City of London Wealth Management Awards Gala Dinner.

<u>LARGER, LONGER AUTO LOANS SPARK DEBATE</u> (G&M, Greg Keenan)

- The Bank of Canada has been fretting for some time about the high-, & still rising-, levels of consumer debt in Canada[6] & in December raised a red flag about the volume of new car loans growing much faster than the economy (in the Fourth Quarter it was up 13% YoY[7]). But it has since become even more concerned about new car loans because, to keep monthly payments low, lenders have been lengthening the term of car loans to as

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[5] The subsidization of alternate energy is often scathingly criticized by fossil fuel proponents (who conveniently overlook the fact that, in part due to their lobbying efforts, their own industries have benefitted, & continue to benefit, from preferential tax treatment by law makers). Be that as it may, the subsidization of alternate energy sources may, at least in the case of solar, prove to have been a positive example of the 'infant industry' argument (that holds it is appropriate to subsidize fledgling new industries until they gain sufficient critical mass to make it on their own); for there is growing empirical evidence, that a Moore's Law 2.0 apply to solar panels (*Gordon Moore noticed in 1965 that the number of transistors per square inch on integrated circuits had doubled every year since their invention & postulated, & subsequently proven correct, that this would continue for years to come (the root cause for the ever-declining cost of ever-better electronic equipment).*

[6] Until the onset of the Great Recession, consumer debt growth in Canada & the US moved on parallel, albeit in Canada somewhat higher, paths. But since early 2008 they have diverged; for in the US the household debt-to-income ratio peaked at 130+% in 2008 (& now is in the 100% range) while Canada's kept growing (albeit since 2010 at somewhat slower rate) to the point it now is North of 150%. Much of this is home mortgage debt and, given a recent report that Canada will lose 185,000 direct & indirect jobs due to the lower oil prices (half of them in Alberta where the lion's share of high leverage mortgage loans are situated), things could get 'sticky' in the Canadian housing market, since despite the record low mortgage rates, the RBC's Home Affordability Index for detached homes stands at a not-quite-nosebleed-high 42+% (especially so in Alberta where a disproportionate number of the country's high-leverage mortgage loans are situated.

[7] In 2013 new vehicle sales hit a ten-year record (although YTD they seem to have slowed some).

much as eight years[8] (*not unlike what home mortgage lenders did a few years ago when they started offering 35-year mortgages, a move the then Finance Minister, the late Jim Flaherty, fairly quickly nipped in the bud).*

Some industry insiders are starting to worry this is just 'robbing Peter to Paul' by pre-empting future demand since three years hence, when it would otherwise have been 'time' for them to shop for a new car, car owners may find that their existing vehicle's trade-in value is less than they still owe on it. The day before yesterday the Fraser Institute came out with a report by a former Chief Economist at StatsCan that pooh-poohed the idea that Canadian consumers' debt load is dangerously high because, he says, two-thirds consists of home mortgages backed by real assets which should-, & can safely-, be ignored; for the author makes the classical error of failing to distinguish between a "stock" (the value of the underlying asset) & a "flow" (the cash flow available to service the debt secured by that asset) : throughout history Illiquidity (i.e. the inability to service debt) has accounted for far more bankruptcies than insolvency (the lack of assets held as security for the debt).

PALESTINIAN BUS SEPARATION SAGE : ISRAEL CANNOR BURY THE DAMAGE DONE (Haaretz, Amos Harel)

- Early this decade a report criticized security at the Israeli-West Bank border crossing points since buses carrying both settlers & Palestinians from their homes in the West Bank to their places of employment in Israel cannot be properly security checked at the border since the settlers traveling on the buses reject being delayed at the crossings points to do so. So a year ago Defense Minister Moshe Ya'alon's office, despite protests by the military that stricter border crossing controls wouldn't necessarily reduce security risks & Department of Justice warnings that it would be 'legally problematic", began to make plans to have separate buses for Israelis & Palestinians (a process which, once started, gained momentum from settlers' claims that Palestinian labourers posed dangers to their women if both traveled on the same buses).
- Late May 19th, without having given Prime Minister Netanyahu a 'heads-up', the Defense Ministry announced the plan's implementation, immediately setting off a storm of protest at home &, particularly harshly, abroad. And the very first person to denounce it was the right wing former Interior Minister Gideon Sa'ar who tweeted that this was a mistake & damaging to both the settler movement as a whole & to Israel's status in the world, and called for its immediate cancellation. It also angered President Reuven Rivlin, also a strong right winger, *albeit one with a strong human rights' conscience*, who said that separation between passengers was "inconceivable" & scolded supporters of the idea for failing to protect the *democratic* founding principles of the State of Israel.
- Early the next day, May 20th, Netanyahu, who had known of Ya'alon's intentions but not of his timing, made a public U-turn when, after talking with Ya'alon over the phone, the latter's media shill issued a statement to the press saying the two had "agreed to suspend the pilot (*separate bus scheme*) at the Judea and Samaria crossings". For Netanyahu was to have a meeting later that day with Federika Mogherini, the EU's Foreign Minister, that would be followed by a joint press statement & didn't relish the idea of being publicly taken to task by her & being grilled by foreign reporters. But Ya'alon is dug in on the idea & is expected to re-introduce it at a later, more convenient date (somewhat surprisingly so since in recent years he has been a voice of moderation on sensitive issues) & he appears to be tone deaf on the bigger diplomatic picture. And,

[8] In April car loans of six years or more accounted for 66% of the total (down from 69% last August).

if & when he re-introduces it, it is expected to no longer be a pilot *project* but to apply to all 13 crossings [*& he will then have a willing handmaiden in the photogenic lady who is the new Justice Minister (from the Jewish Home Party), who is as rabidly anti-Arab/ Palestinian as they come*].

Several years ago, an Israeli commentator, after Obama had failed to pro-actively exert pressure on Netanyahu to avoid an extremist move, commented that by doing so "he gave a green light to someone who doesn't even stop for red lights'; this now seems to increasingly apply to more politicians in general, & to his latest Cabinet in particular.

BOJ CHIEF ECONOMIST EXPECTS JAPAN TO MOVE INTO EXPANSIONARY PHASE (Reuters, Stanley White)

- Eiji Maeda, Head of the BOJ's Research & Statistics Department, says Japan's economy is likely to shift to an expansionary phase this fiscal year [with growth to exceed its zero to 0.5% trend growth rate (whereas it was 0.4% in both Fourth & First Quarters)] due to improvements in domestic demand & exports, and the windfall from last year's decline in oil prices. Furthermore that, because the country is now at near full employment, which will put upward pressure on wages, the BOJ will likely meet its 2% inflation rate goal in the First Half of fiscal 2016 (which in its case **starts** on April 1st, 2016 rather than **ends** the day before) & that hence there is no need at this time for further easing of (*monetary*) policy.

Nevertheless, if his growth & inflation prognostications are proven wrong, there will be a policy response (but none if he were proven to have been too conservative in his forecast).

INDONESIA SINKS 41 FOREIGN FISHING BOATS TO WARN AGAINST POACHING (China Daily)

- On May 20th, the Indonesian authorities, as a warning, blew up & sank 41 Chinese, Malaysian, Philippine, Thai & Vietnamese fishing vessels that had been caught illegally fishing in Indonesian territorial waters. According to Fisheries Minister Susi Pudjiastuti several others had already been so disposed of since the election of President Joko Widodo *last July & his taking office three months later*, one plank of whose platform had been to manage the rich fish stocks in its waters with a view to perpetuate them to the benefit of future generations.

This was its way of celebrating National Awakening Day, a national holiday that commemorates the founding, on May 20th, 1908 of Budi Utomo *(Prime Philosophy), the first native political society in what was then the Dutch East Indies (albeit one dominated by 'high class' natives, many of whom were doing quite well under the colonial system). But this could lead to problems given the many conflicting territorial claims in the South China Sea & its surrounding waters.*

GREECE SAYS IT WILL DEFAULT IN JUNE WITHOUT AID FROM LENDERS (Reuters, Renée Maltezou)

- Nikos Filis, a spokesman for Syriza law makers, told ANT1 TV on May 20th that Greece cannot make the next (*300MM Euro interest*) payment to the IMF *due on June 5th* unless foreign lenders disburse more aid &, more specifically, that "Now is the moment that negotiations are coming to a head,. Now is the moment of truth, on June 5th ... if there is no money by then ...to address the current funding problem, they won't get any money."

- Four days before the last (750MM Euro) payment was due to the IMF, Prime Minister Alexis Tsipras sent a letter to the EU & the IMF warning Athens couldn't make the payment, only to do so, at the last moment, by ordering SOE's to hand over their cash & stripping 600+MM Euros out on an IMF reserve account in the central bank, leading to accusations by creditors of bluffing that *further* deepened their mutual mistrust.

While Prime Minister Tsipras & his Finance Minister Yanis Varoufakis in their pronouncements have been making soothing, Alfred E. Neuman "What? Me worry?", 'it's all going to work as we told you' noises, on May 19th, after meeting in Berlin Germany's Chancellor Merkel & French President Hollande, stood side-by-side in front of cameras & gave Tsipras a firm May 31st deadline to meet their demands (that now include a reversal of his recent rollback of the previous government's pension & labour reforms, and public sector employee layoffs).

<u>ECB SAID TO BE UNLIKELY TO CUT GREECE LOOSE</u> (NYT, Jack Ewing)

- So far the bank has lent over 110BN Euros (US$125BN) in "emergency liquidity assistance" to struggling Greek banks (up recently in weekly increments from an initial 'ceiling' of 80BN Euros); so if Greece were to go bankrupt & caused the country's banking system to collapse, it could suffer huge losses. Hence, according to a person familiar with its thinking, the ECB Governing Council at its meeting in Frankfurt this week, despite its unhappiness with the Greek government's handling of the debt negotiations, was not expected to do anything that would provoke a crisis by restricting the *continued* flow of emergency cash to the Greek banks (*part of which offsets the ongoing drain on their deposits & part of which goes to buy government securities that helps to keep the government afloat*).

Nevertheless it must have rubbed the ECB the wrong way that, after first upsetting the Germans by making huge claims for Nazi era damages, the Tsipras crowd recently said it was entitled to the ECB's trading profits on Greek government bonds. It seems that everyone is just biding their time until Greece solves their immediate problem by defaulting (which, contrary to what the article infers, would not mean bankruptcy, just that it would quit paying interest on its debt, as Argentina has done twice in the past 13 years, & Greece itself has done no fewer than five times during its now nearly two centuries-long history as an independent state). And Tsipras c.s. have misread the situation; for the opposition to giving in to his government's demands doesn't just emanate from fiscal hawks like Germany, Netherlands & Finland but equally, if not more so, from fiscal miscreants like Spain & Portugal whose governments fear that, if Syriza's demands are met, this will, in their forthcoming elections, strengthen the hands of the Syriza 'think-alike' parties in their own countries. And it is telling in this context that the agenda for this week's EU Leaders' Summit in Riga, Latvia was focused on Ukraine, not Greece & that the discussion of Russian sanctions (that would require unanimity) was deferred until their next meeting, in June.