Quote of the week : “We are facing the end of the commodities supercycle.” - Brazil’s *left-of-centre* President Dilma Rousseff. After *barely* winning re-election (51.6 to 48.4)[1] less than a year ago, she now has a popularity rating of 7.7%. And she is up to her ass in alligators[2], incl. an economy sliding into recession, rising unemployment & inflation, a deteriorating fiscal situation forcing ‘austerity’ at the worst possible time, a corruption scandal that reaches into the top echelons of both public-, & private-, sectors (incl. politicians) & has the potential for splattering her with mud, and social unrest due to a popular perception of inappropriate spending on ‘marquee projects’ for the 2014 FIFA World Cup & the 2016 Olympics at the expense of more socially beneficial infrastructure investments. On top of that there is a once-in-a-century drought in Sao Paulo State, home to the largest city in Brazil (& the Southern Hemisphere) & to 6% of Brazil’s population, and the country’s commercial & industrial capital[3] - *in part by her own doing she may end up with a track record like Lulu’s predecessor, the centrist Fernando Henrique Cardoso (that Lulu thanks to the commodities boom evaded) of having a second term worse than her first*.

A quick perusal of a May 2015 report, that can be googled, by Mark P. Mills, a physics graduate of Queen’s University & now, among others, a Senior Fellow at the Manhattan Institute[4], entitled SHALE 2.0 - Technology and the Coming Big Data Revolution in America’s Shale Oil Fields, yielded four intriguing insights. A prediction that “Shale 2.0 promises to ultimately yield break-even costs of $5-$20 per barrel *in the US shale*, the same range as Saudi Arabia’s vaunted low cost fields” (*that could be the end of the Alberta economy as we have known it for the last seven decades much sooner than anyone expects*). Shale 1.0 was not-, & Shale 2.0 will not be-, the result of government incentives (*other than the tax incentives that have long been a hallmark of the oil & gas industry?*). Technology is causing the rig count to disconnect from the number of feet drilled (*which will rob economists from a gauge of long standing of oil service industry health*). And the cumulative distance of horizontal oil well drilling has gone from 525MM ft in 2008 to 1.82BN ft this year.

Jeffrey Gundlach was a successful bond manager at the Carlyle Group-controlled, Los Angeles-based TCW Group until fired in 2009. He then co-founded Doubleday Capital in the same city that, at last report, had AUM of US$76BN, incl. US$47.2BN in a Total Return Fund he manages that mostly invests in MBS & which in July, its 18th consecutive month of inflows, attracted US$390MM in new money (much of it from former investors in PIMCO’s Total Return Fund,

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1 The narrowest margin of any Brazilian presidential election in 25 years.

2 The continuation of which is “it’s difficult to remember that your initial objective was to drain the swamp” (*or in her case, & that of her predecessor, Lula da Silva,* in the latter’s words in an interview in 2009 “to end the paralysis of the 80's and 90's ... (*and*) get back on the road to growth, and invest in infrastructure as the precursor for success in future decades.”

3 While the drought has hit Sao Paolo state hardest it has also affected the adjacent Rio de Janeiro-, & Minas Gerais -, states, the three of which are the richest states in GDP terms, as well has the most populated (between them they are home to about 40% of Brazil’s 200MM inhabitants).

4 A conservative, New York City-based think tank founded in 1978 by two interesting chaps. One was Antony Fisher, an Eton & Cambridge alum, and WWII RAF fighter pilot, who was a friend of von Hayek, founded Britain’s first battery cage chicken farm (that made him a millionaire) and spent his money founding think tanks all over the place. And the other was William J. Casey who spent his war years in the OSS, served as Chairman of the SEC in the 1970s, was Reagan’s campaign manager in 1980 & served him as Director of National Intelligence from 1981-1987.

once the world's largest bond, that has shrunk to one-third its once US$300BN AUM base after founder Bill Gross was seen lost his touch & ultimately left before being fired?). Many people hang onto his every word & on August 18th he oracled "to raise interest rates now, when junk bonds are nearly at a four-year low is a bad idea ... *it* opens the lid on a Pandora's box of a tightening cycle ... *for* the Fed historically starts something and they continue on with it as long as the situation stays largely similar ... *but* If you start raising rates after such a long period of zero-bound rates, it's a different regime." Furthermore "the global economy is weak ... copper has just slipped below a psychological(*ly important*) US$5,000-a-tonne level ... you get much more downside in commodities and it could really spiral *downward*."

That same day a leading US bank summed up the global situation as follows. Sentiment globally is exceptionally gloomy & becoming more so by the day. The US is doing OK but the big inventory buildup will harm Second Half growth. Europe's 2Q GDP numbers fell short and the EMs are suffering & experiencing ongoing jitters about a nascent currency devaluation 'war', capital outflows, shrinking growth & the prospect of tightening by the Fed & BoE. But it concludes : "these fears are not completely misplaced but seem overstated at this point ..."

Donald Trump demonstrated his populist bent/geopolitical ignorance/willful disregard for facts when after last week's yuan devaluation he accused Beijing of "currency manipulation" when in reality in the past three years the yuan had been flat against the US$ as the Korean won declined 5% vs. the dollar, the Indian rupee & Taiwanese dollar 10%, the Russian ruble 40%, Brazil's real 45% & the Yen 50%. Moreover, with Chinese wage rate growth still 9.5% (down from 14.3% three years ago), Chinese manufacturers have been 'priced out of' export markets.

According to the New York Fed US student loan debt hit a record US$1.19TR in the Second Quarter, more than triple what it had been a decade earlier (thereby sustaining the decades-long practice of US universities to jack up tuition fees at rates in excess of 2x the inflation rate). And after a period of consumer deleveraging during-, & following-, the financial crisis, total non-mortgage/non-student loan consumer borrowing is once again on the rise, at an accelerating rate (by 7.0% in 2014, 6.0% in 2013 & 2012, 4.1% in 2011 & minus 1.0% in 2010).

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Thursday August 20th, 2015

MARK CARNEY SENDS GOLDMAN AN EARLY INVITE TO THE NEXT BAILOUT PARTY
(The Independent, Jim Armitage)

- The last time around, in 2007, to stay afloat Goldman had to depend on one of its alums, the then US Secretary of the Treasury Hank Paulson, giving it access to billions of dollars of US taxpayer money via the US$85BN AIG bailout, but as a bank with non-British status couldn't tap the British taxpayer. But now a deal arranged by another of its alums, Bank of England-, & ex-Bank of Canada-, Governor Mark Carney has solved that problem; for in another such crisis the Bank of England will offer emergency liquidity support to all banks in the City (*of London*) to ensure the market won't seize up as it did in 2007 (*when banks would not even lend each other money overnight*).

While contingency planning behind the scenes is always a wise thing to do, it is disconcerting that the Bank found it necessary, or even desirable, to announce this publicly'; for in a best case scenario, this will encourage moral hazard-type activities by banks & in a worst case might be interpreted in a 'where there's smoke, there's fire' manner.

<u>RAISING RATES NOW WOULD BE A MISTAKE</u> (WSJ, Narayana Kocherlakota)

- People are calling for the FOMC to raise interest rates soon. But this would create risks for the US economy & push it away from the FOMC's economic goals. The Fed has translated its Congressional mandate to promote price stability & maximize employment into a target of 2% inflation, as measured by the personal consumption expenditures price index (PCE). But it has now consistently been below that level for three years & is currently 0.3%, with the outlook for more of the same; for most private forecasters do not see inflation reach 2% for the next two years & in June our own staff forecast it will remain below 2% until the 2020s. So at this juncture we should ease, not tighten monetary policy, for instance by buying more long-dated assets or reducing the 0.25% interest rate the Fed pays banks on their excess reserves[5].
- This is not to say that hiking the Federal Fund rate, as many advise, by 0.25% (to 0.50%) would in, & of, itself have a huge direct impact on the US economy. But even a small change would send a strong message to financial markets; for if the Fed raised interest rates when inflation is so far below target, market participants could conclude we had cut our inflation goal. That would pose two serious risks to the economy. Short term real interest would go higher, making the holding of assets less attractive, discouraging consumption & creating a drag on economic & employment growth. And longer term financial markets may see this as the FOMC moving away from its 2% inflation goal set in 2012. And by *being seen as* setting policy in a direction opposite to its stated goals, a central bank loses credibility & will be much less able to fight recessions effectively.
- I am confident the time will come when economic conditions will be appropriate to raise the federal fund rate from its current low level. But that time is not now. Tightening monetary policy when inflation is projected to be so low is a step in the wrong direction.

It's hard to know where to start commenting. The second paragraph's lead sentence, a direct quote from the article, undermines the thrust of his argument, as does the final paragraph. "Now" is never a good time to do unpleasant things. While he stresses that Congress gave the Fed a dual mandate, his presentation is, seemingly almost obsessively, preoccupied with inflation couched in terms of an assertion that 2% constitutes "price stability" and barely even genuflexes to employment growth; gone are the days that former Fed Chairman Ben Bernanke set a 6.5% unemployment rate as the possible threshold for moving on interest rates (it is now 5.5%)[6]. While he uses the June 'headline' PCE number, core PCE (i.e. less food & energy) was up 1.3% (in recent months the effect of the higher cost of "need" items like shelter, which the PCE vastly underweights[7], & food, has been offset by lower prices for 'want' items like airline

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5 That have skyrocketed from next to nothing in 2008 to US$1.7+TR at last report.

6 Although he weaseled out of this over a 12 month' period ended in December 2013. For in December 2012 the Fed 'committed' itself, when the unemployment rate was 7.7%, to keep short-term interest rates near zero until it would be 6.5% or less. Six months later, when the rate had surprised people by declining to 7.0%, it qualified this by saying the 6.5% rate was "a threshold, not a trigger point". Three months after that Bernanke said "the unemployment rate is not necessarily a good measure ... of the state of the labor market overall" (since it was affected by people leaving the work force). And, finally, in December 2013 he announced the Fed would be looking at other gauges of labor market health other than just the unemployment rate.

7 According to Société Générale in 2014 the two CPI & PCE 'baskets was constituted as follows (in % with the CPI first & the PCE in brackets) : Shelter 31 (15), Transportation 17 (10), Food & beverages 15 (14), Education 9 (7), Medical care (7 (20), Other housing 7 (5), Recreation 6 (9), Apparel 4 (3), and Other goods & services (*which could a whole multitude of sins) 3 (16)*

fares, new & used cars & household furnishings) and, according to the BLS, the CPI for all urban consumers, not seasonally adjusted, that had declined in six of the seven months ended last January has since increased by 2.1% (i.e. at close to a 5% annual rate). As to preserving the Fed's credibility, its strategy since the end of the Great Recession in December 2009 has already been seriously undermined its credibility & the longer it keeps waffling, the more likely it is to keep eroding. And as to its ability to fight a recession, with its benchmark interest rate near zero, it has lost its primary pump-priming tool - The writer is President of the Minneapolis Fed, and this year & next a non-voting member of the FOMC who, according to Deutsche Bank Chief US Economist Joseph Lavorgna, last year, when he was a voting member, was one of three of its ten voting members that, on a scale of 1-5, with 1 being most dovish, had a "1" rating (the other two being Chairman Yellen & New York Fed President Dudley).

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BULKY US INVENTORIES CAST CLOUD ON SECOND HALF GDP GROWTH
(Reuters, Lucia Mutikani)

- Business inventories grew by an unusually high US$112.8BN in the First-, & US$110BN in the Second-, Quarter, and some expect the latter number may be revised to as much as US$130BN. Since this wasn't matched by equally robust sales growth, the inventory-to-sales ratio is now at a near six-year, Great Recession high of 1.37x (well outside the 1.25x-1.30x 'comfort zone'). So according to Tim Quinlan, an economist at Wells Fargo Securities in Charlotte, N.C., unless sales growth accelerates faster than expected "we will end up with inventories being a drag on *GDP* growth in the Second Half."

While this inventory buildup may have added 0.5% to Second Quarter GDP growth, JPMorgan has postulated that, if the Second Quarter inventory buildup number were revised upwards to US$130BN, the resultant drag on Third Quarter GDP growth could be as high as 1.4% (& it actually cut its Third Quarter GDP growth forecast by 1.0% & announced it now expects the Fed not to initiate a rate hike until mid-2016). Meanwhile the Atlanta Fed's GDPNow real time Third Quarter GDP growth forecast on August 13th was 0.7%, down from 0.9%-, & from1.0%, one & two weeks earlier (& it upped the drag created by the inventory buildup from 1.8% to 2.2%) - Given the anemic 0.6% (revised) growth rate in the First-, & the (inventory-overstated) preliminary 2.3% for the Second-, Quarter, it may prove difficult, if not impossible, for US GDP growth for the year as a whole to meet earlier 2.5% - 3.0% expectations.

WALMART AND OTHER US COMPANIES ARE STARTING TO FEEL THE EFFECT OF HIGHER MINIMUM WAGES (Quartz, Shelley Nanjo)

- Raising its minimum wage to US$9.00 in April (& planning to raise it to US$10 next year) has resulted in improved sales & customer experience. But paying workers more & giving them more hours, and rehiring greeters & department heads has translated in an 8.2% hit on its operating income, a lower profit outlook for the year as a whole & a search for savings in its supply chain & elsewhere. While the US$7.25 federal minimum wage rate hasn't changed, 29 states & dozens of cities have introduced minimum wage rates of their own higher than the federal one. As the economy improves, unemployment declines & competition for workers heats up, "the magnitude of [labor pressures] has definitely gotten larger." And the consequences of rising wages are rippling across Corporate America as companies plan to hike prices, slash staff & increase automation; and as Wendy's CEI Emil Brolick told analysts earlier this month "some of these *wage* increases will clearly end up hurting the people they're intended to help".

In theory such a hike in the minimum wage will, over time, result in a more efficient economy as workers gravitate from lower-, to higher-, value-added work. But in the real world many of those affected don't have the skill set needed to do so, or are prevented by economic and/or social rigidities from doing so. And since the mantra of ever-increasing corporate profits is the Holy Grail of today's corporate mindset, the resultant cost increases will be passed on to consumers, endangering the above-noted Fed claim that inflation will "remain below 2% until the 2020s".

<u>ALBERTA ESTABLISHES LIMITS ON OILDSANDS' WATER USE DURING DRY SPELL</u> (Bloomberg News)

- Given the current drier-than-usual-, & above-normal temperature-, conditions in the Province, Alberta's energy regulator this week restricted applications by oil & gas companies to withdraw water from a number of Alberta rivers (& called for voluntary restrictions of withdrawals by holders of existing licenses).The most important river to oilsands operators in the Athabasca. Fed by glacier 'melt'. While it requires a flow of 900 cubic meters per second in summer, when the flow is at its peak. to maintain healthy ecosystems in its watershed, earlier this month it was down by more than one-third.

With changing weather patterns this may well be a harbinger of things to come, & not just in Alberta but also South of the border where fracking, that also requires huge amounts of water, is most commonly practiced in states that are anything but water-rich. But if the Alberta government really expects the oilsands operators to seriously respond to its call for voluntary reductions in water use, it may be dreaming in technicolour, for the profligate use of water is part & parcel of-, & key to-, their current business model.

<u>YUAN SHOCK SENDS SAUDI RIYAL DEVALUATION WAGERS TO SIX-YEAR HIGH</u> (Bloomberg, Arif Sharif)

- For almost three decades the Saudi riyal has been pegged to the US dollar at 3.75 riyals to the dollar. But falling oil prices, a five months' 10% decline in the Kingdom's FX reserves to US$664.4BN from its August 2014 high & the two-step devaluation of the Yuan led to speculation that Riyadh will alter the rate at which the riyal is pegged to the dollar. So on August 12th, the day of the second Yuan devaluation, the pricing of the one year forward riyal contract had its largest one-day surge in over a year. This prompted Farouk Soussa, Citigroup's London-based Chief Middle East Economist to comment "The fall in oil prices combined with the recent devaluation of the yuan are leading to speculation that a devaluation of the riyal is on the cards ... a view we do not share."

Citigroup must be 'long' the riyal (Saudi Arabia has been seeking to expand its oil exports to Asia, especially China and its sales to China are, at Beijing's insistence priced in yuan).

<u>PALESTINIAN LAWYER ON HUNGER STRIKE OVER ISRAELI DETENTION POLICY FALLS INTO COMA</u> (The Guardian, Mairav Zonszein)

- Mohammed Allan (age 31) has been in 'administrative detention' in an Israeli jail since last November[8] as a suspected member of Islamic Jihad[9]. Two months ago he went on a

[8] Along, according to the Israeli prison service, with nearly 400 other Palestinians

hunger strike. On August 7th the International Red Cross issued a warning his life was at risk but doctors at Beersheba's Soroka Hospital refused to force-feed him. So on August 10th the authorities moved him to the Barzilai Hospital in Ashkelon whose doctors also declared they would refuse to force-feed him (although its medical director later told the media he didn't rule it out). On August 14th (Day 60 of his hunger strike), Allan went into a come, the Israeli prison service declared an emergency & a hospital spokesman said "The condition of Mohammed Allan deteriorated this morning. He is receiving treatment and his condition is stable. The treatment is being administered according to the ethics committee guidelines and includes respiration and intravenous fluids and saline."

- The Israeli government has long been concerned that hunger strikes by Palestinians in its jails could lead to deaths that would trigger waves of protest in the West Bank & East Jerusalem (in fact, last month it released another hunger striker, Khader Adnan, after his 54-day hunger strike started endangering his life[10]). So last July 30th, the 120 member Knesset passed, 46-40, a *controversial* law allowing the force-feeding of hunger-striking prisoners if their life was in danger. Among the opponents thereof was the Israel Medical Association that called it "equivalent to torture", declaring "Every physician has the right to refuse to force-feed a hunger striker against his or her will" & has launched an action in the Supreme Court as to the legality of force-feeding hunger striking prisoners. And the Israeli organization Physicians for Human Rights noted "Once Allan lost consciousness, medical ethics requires that his doctors act in accordance to their understanding of the patient's will and their discretion ... (*and that*) the State of Israel is responsible for his health."

Administrative detention laws have in recent years become part of the legal framework in Australia, the United Kingdom & the United States although in Israel's case they date back to the pre-Independence era (& after the recent firebombing of the Dawabshe West Bank family home that killed an 18 months-old boy & his father has been used against Jewish extremists).

MERKEL RULES OUT DEBT CUT, SAYS BAILOUT MAY NOT SUCCEED (AP)

- She told the German broadcaster ZDF on August 16th that there is no certainty that the latest Greek bailout will succeed but that she is hopeful that Greece can overcome its economic crisis if it adheres to the agreements now forged with its creditors. But while IMF Managing Director Christine Lagarde insists Greece must be given debt relief in the form of write-offs before it will participate, Chancellor Merkel insists that while repayment periods may be extended & interest rates 'tweaked', a "haircut" is out of the question.

Both 'talk her own book' : the IMF is not allowed to participate in debt write-downs & Merkel knows German interests will take biggest hit in any haircut; in addition, she has political problems : while the German Parliament passed the recent Greek deal 454-113 (& 18 abstentions), 63 of her 310 fellow Christian Democrat MPs were among the naysayers & another three abstained. Meanwhile, Greek Prime Minister Alexis Tsipras, faced with a rebellion

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[9] Founded in 1981 it is committed to the destruction of Israel & the creation of a sovereign Islamic state (although, according to its leader it would not be opposed to a one-state solution although he believes that Israel has no more interest in a one-, than in a two-, state solution)

[10] The second one for him; for he was released in 2012 after a 66-day hunger strike (that equaled the record set by Bobby Sands, an IRA activist who died on May 5th, 1981 in Northern Ireland's Maze Prison, a month after being elected, by a narrow majority, to the UK House of Commons in a by-election necessitated by the sudden death of the Independent Republican incumbent).

among the left-wing elements in his party, resigned on August 20th & asked the President for an "early" election date (September 20th?) in the (unlikely?) hope of getting an outright majority in Parliament, after telling his fellow citizens in a TV address that "we did not get the agreement we had expected."