<u>GLEANINGS II - 729</u>
Thursday September 28th, 2017

Quote of the week - "I wouldn't call it healthy, I'd call it obese. But you know, some of these obese people live to be 100 years, so you'd never know." - Nobel Laureate & Sterling Professor of Economics at Yale University Robert Shiller (age 71), the creator of the CAPE (Cyclically-Adjusted Price Earnings ratio) concept. While the CAPE ratio in the 30x range is at a level not seen since 1929, he still does not entirely rule out that for reasons of psychology the US stock market may still have some more life in it before finally coming down to earth - *On the other hand there is an old Wall Street adage that "Bulls make money and bears make money, but hogs get butchered."*

Amadeus IT Group - Over 130 airlines worldwide, incl. BA, Lufthansa, KLM, Cathay, Quantas & Southwestern, use the passenger service system of this Madrid-based, 10,000+ employee firm to manage their flight reservations-, & departure control-, activities. So thousands of travelers worldwide were inconvenienced on September 28th when it had "network issue" software problems.

Misallocation of resources? - According to the Vancouver-based, well right-of-centre <u>Fraser Institute</u> in 2015/16 Canadian governments spent $62.8BN on interest payments whereas two years earlier (the last year for which there are final data) they had spent $63.9BN on primary & secondary education - *the situation is unlikely to have gotten any better since; for most Canadian governments, with the Federal-, & Alberta-, ones enthusiastically in the van, are adding to their debt loads at a much faster clip than they have been hiking their spending on education.*

The Trump/GOP tax plan - Two WSJ headlines were "GOP pitches deep tax cuts with few details on paying for them" & "Trump and his Congressional allies are about to make the trajectory of debt even worse", while Politico's read "Trump/GOP tax plan omits details on who pays for it" - *The last concerted GOP tax cut drive 35 years ago was launched when the nation's debt-to-GDP ratio was 35% (& drove it to 54% eight years later) whereas now the 'base line' is in the 105+% range. In the short run the plan is likely to give a fillip to both the GDP growth-, & inflation-, rates.*

Trump the weakest president since the 1920's? - Walter Shapiro, a Fellow at New York University's <u>Brennan Center for Justice</u> in an OpEd piece in <u>Roll Call</u> (a paper published when Congress is in session that was founded in 1955 & since 1993 has been owned by <u>the Economist</u> and that is delivered free of charge to Congress & the White House) postulated that the modern US presidency has three dimensions -presiding over foreign policy, managing the federal government & providing legislative leadership- and that Trump has (*dismally?*) failed in all three.

Trump has 'declared war" on North Korea - Trump told the UN the North Korean regime's leaders "won't be around much longer". Shortly thereafter US B-1 'Lancer' bombers escorted by US F35B stealth-, & South Korean F-15K-, fighter jets flew off North Korea's east coast further North of the DMZ than any US plane has flown this century (according to the Pentagon "to show the range of military options available to President Trump"). Shortly thereafter North Korea's Foreign Minister Ri Yong-ho told the UN General Assembly that Trump had declared war on his country,& White House spokesperson Sarah Huckabee Sanders "the suggestion of that is absurd" - *Be that as it may, Trump doesn't need to do so; for since a peace treaty was never signed following the Korean War half a century ago, the two countries are legally still "at war"*

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TOP BP EXECUTIVE WARNS OPEC NEEDS TO PROLONG OIL OUTPUT CURBS
(Bloomberg, Heesu Lee)

- After a career at the China International Capital Corp., Goldman Sachs *& the Hongkong Monetary Authority, the Georgetown University-educated* Janet Kong last January joined BP as its Eastern Hemisphere (*i.e from Suez to Japan)* CEO of Integrated Supply & Trading. In an interview during the annual APPEC (Asia Pacific Petroleum Conference) meeting in Singapore she said that OPEC needs "definitely to cut *output* beyond the First Quarter" *of next year* to bring inventories down to historically normal levels and that, if it were to do so "it's possible" to achieve $60 oil next year although "it's hard for me to see" prices going substantially higher. And asked whether she would be a buyer or a seller of Brent at $60, she said "I will sell that".
- Strong global economic growth[1] has been boosting oil consumption to well above historical levels, helping to draw down stocks (demand growth this year will be in the 1.7-1.8MM bbld range, well above the 1.2MM bbld 10-year average, (although she sees that declining to 1.4-1.5MM bbld next year). She bases her view on the fact that the US shale oil producers can, & will, boost output quickly at US$60 oil, saying "that's the interesting thing about the shale presence in the world. They are so short-term-focused and very responsive."

Ed Morse, Citigroup's Global Head of Commodities Research doesn't agree; in his view Libya, Nigeria, Venezuela, Iran & Iraq have been pumping at capacity & not investing enough in exploration & development to further increase (or even maintain?) this rate of production. So he foresees a "squeeze" next year (when demand would outstrip supply). On the other hand, a Financial Times report on APPEC points out that "China has helped to clear up the market" by aggressively adding to its SPR (Strategic Petroleum Reserve) when oil prices are weak, inflating demand & raising concerns any slowdown in its rate of SPR accumulation could reduce demand by several hundreds of thousands bbld. And it pointed out that China has been importing oil at a 8+MM bbld rate & this year may replace the US as the world's biggest oil importer

FED'S ROSENGREN SAYS 'REGULAR AND GRADUAL' TIGHTENING WARRANTED
(BB, Jeanna Smialek)

•In a September 27th speech to the New York University's Money Marketeers[2] the Boston Fed President contended it should raise rates in a "regular and gradual" way in spite of the *current* low inflation rate since the weak price pressures appear temporary & a tight labour market risks overheating the economy. He said "Appropriate risk mitigation would argue for continued removal of the monetary accommodation even though we are currently below the inflation target ... I believe policy makers should not overreact to the low current inflation expectations that are widely expected to be temporary" and that, as

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[1] In its July World Economic Outlook update the IMF forecast 3.5% for this-, & 3.6% for next-, year, *well up from 2.44% in 2012, 2.60 in 2013, 2.83% in 2014, 2.73% in 2015 & 2.44% in 2016.*

[2] A charity set up in 1946 to provide greater educaTional opportunities for aspiring financial professionals at the university's Stern Scholl of Business.

unemployment continues to fall, the risk increases “an overheated economy will lead to price or asset-price inflation, risking the sustainability of the recovery.” He also warned that “Discerning the underlying trends in unemployment and inflation ... is likely to be quite difficult in coming months (*because of the hurricane effects*) ... *so* it may be difficult to be fully ‘data dependent ‘in the near term.”

Eric Rosengren (age 60), a Bosten Fed ‘lifer’ , has been its President for a decade. He is this year not a voting member of the FOMC (& won’t be again until 2019). In the past year he has been more hawkish than Fed Chair Janet Yellen. So he must not have had much difficulty in following her siren call for continued policy tightening that she had laid out the day before in her speech to the NABE (National Association of Business Economists) Annual Meeting in Cleveland OH, whom she told it would be “imprudent” to keep rates on hold until inflation was back at the Fed’s 2 percent target (thereby joining those of her officials who are concerned the persistent labour market tightness will push prices higher & that waiting too long to raise rates could allow inflation to get out of hand &discarding the view of those who believe that raising rates before inflation shows (more?) progress in increasing towards 2 percent could make it harder to reach that target).

JUDGE ROY MOORE WINS ALABAMA SENATE PRIMARY (Vox, Jeff Stein)

- On September 26th, in a big blow to the GOP establishment & President Trump, *former Alabama Supreme Court Chief Justice* Roy Moore won the State Republican primary, beating Sen. Luther Strange, *the State Attorney-General for six years until appointed to the Senate by the then Alabama Governor Robert Bentley to fill the vacancy created by Sen. Jeff Sessions becoming US Attorney-General.* He did so despite Strange having 10x outspent him & having the support of both the GOP establishment & of President Trump (who attended his September 22nd final campaign rally). But he did have the support of populist Steve Bannon (*Trump’s former strategy adviser now back at Breitbart where he was quoted as saying “At the White House I had influence, here I have power”)* who during the campaign had said “We need more candidates who follow the model of Judge Moore and don’t need to raise money from elites, fat cats, crony capitalists in Washington, D.C, and New York City.” Sarah Palin too had backed Moore & her Chief of Staff said Moore’s win showed “Tea Part types making further gains in the GOP” & “there’s only more Donald Trumps & Roy Moores coming in 2018".

As Chief Justice Judge Moore was twice reprimanded for ignoring United States Supreme Court orders that conflicted with his personal belief that God’s law (as he interprets it?) is supreme over Man’s. He doesn’t believe that Muslims can serve in Congress, has addressed white supremacy groups & at one campaign rally pulled out a pistol & waved it in the air (to refute claims he was pro-gun control) to wild applause from his audience. In the December 12th election the Democrats are not expected to have much chance of beating him since this is a ‘deep-red’ state in which Republicans outnumber Democrats 5 - 3 & Trump beat Hillary by 30 points. Almost coincident with this news came an announcement by 65 year-old Sen. Bob Corker (R.-TN), the Chairman of the powerful Senate Foreign Relations Committee, a “moderate” & compromise-inclined member of the GOP caucus, that he would not run for a third term a year from now, promising to work “thoughtfully & independently” during his remaining 15 months in office - Vox is an Internet-based media outlet founded three years ago by Washington Post alumni with ‘politically liberal’ views.

RESURRECTED TPP COULD GET DONE THIS YEAR AND CANADA IS BETTER OFF WITHOUT THE US IN IT (NP, John Iveson)

- When, *as one of his first moves as President,* Trump (*foolishly, one of his critics called it a "Christmas present for President Xi"*[3]) pulled out of it, that was thought to be the end of it. But it has been quietly revived by the other 11 signatories whose officials met in Tokyo on September 20th for the third time, with those of Canada, Japan & New Zealand expressing optimism afterwards that a deal will be signed at their next meeting in Vietnam in November for implementation next year.
- Canada's Liberal government is now among those most actively promoting the idea. For Canada's spectacular growth this year was in part due to a strong export performance (YTD exports are up 9.4% YoY) that recently faltered, in part due to the stronger Canadian dollar, as in July exports were down 4.9% MoM (*after being down 4.3% in June as the merchandise trade balance slid from -$1.4BN in May to -$3.6BN in June*). Much of this was due to a sharp drop in agri-food exports to Japan, which recently introduced a 50% duty on beef imports that doesn't apply to Mexican & Australian beef since those two countries already have bilateral trade deals with Japan in place).

So if the now TPP 11 goes ahead, Canadian beef producers can gain market share from their US counterparts & the US TPP withdrawal will do them a favour & hurt their US counterparts.

<u>'BORROWING BINGE' RAISES A RED FLAG</u> (FP, Garry Marr)

- In a recent Moody Analytics' report Brendan LaCerda employs "mortgage meltdown math" to paint an ugly picture of what could happen to the Canadian economy if everything were to go wrong in its housing market. He notes that, according to the BIS, in Canada credit to the non-financial sector[4] amounts to 217% of GDP vs. an average 154% in 42 other (*mostly OECD?*) countries & that the federal government is at risk because it owns 100% of CMHC (Canada Mortgage and Housing Corporation) that has provided default insurance coverage for over half of Canada's home mortgages (& the riskiest half at that since it takes down payments of < 20%[5] to qualify for CMHC insurance) & has 90% backed the two private companies that have provided it for the other half. He then says " Canadians' borrowing binge has put the economy in a precarious position ... inducing fears of a bubble. If a recession were to hit the economy, many households would find themselves with negative equity & reduced incomes, raising the spectre of a swell of non-performing loans as homeowners default ... Fortunately, the government's finances appear healthy enough to sustain a large bailout in a severely adverse scenario ... (*But*) even if CMHC realized a total loss on its more than $500billion of insurance guarantees, which is nonsensical given the collateral value of the underlying homes, and the government completely bailed them out, its debt-to-GDP ratio would rise to about 105 percent (*from 79% in the first quarter of 2017*) ... Such an increase would raise Canada above the US."

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3 For it was only masquerading as a trade deal; it's real purpose was political, to create an obstacle to China's growing influence in the Pacific Basin

4 That includes households, non-profit institutions serving households (*incl. credit unions?*) & non-bank financial corporations.

5 Which prompted LaCerda to observe that "the loans that CMHC is insuring have a smaller-than-average equity cushion."

Last July CMHC announced that in the Fourth Quarter the mortgage delinquency rate had been 'the lowest in decades' (for all that's worth in Ontario in the late 1980s/early 1990s it too it had been at a low, after a extended runup in house prices, just before they declined 40% in 7 years & in 2005 in the US they too had been low just before the housing bubble popped there. And according to the CBA (Canadian Bankers' Association), that tracks mortgage delinquency rates (i.e. over three months in arrears) at ten institutional mortgage lenders, they had been 0.14% in 2007, 0.83% in 2010 & 0.27% in 2015, and at last report was back up to 0.47%. A run-up in house prices such as Canada has just experienced[6] creates 'new equity' in exiting houses that home owners often do 'monetize', especially when interest rates are low, by hiking their existing mortgages or lines of credit. And while something in the Canadian psyche is said to prioritize keeping up one's mortgage payment obligations when money is tight, that is often done by way of running up higher cost credit card-, and/or home equity line of credit-, balances. And in Alberta. where there is a disproportionate share of CMHC-insured (i.e. low equity) loans (many on 'oversized' houses) & where it is easier than elsewhere in Canada to 'walk away' from an 'underwater' mortgage, foreclosures were up 25% in each of 2015 & 2016 - Unfortunately his "national debt"-to-GDP numbers are pretty 'iffy'

NEW SINGLE-HOME CONSTRUCTION UP FOR SEVEN MONTHS RUNNING
(CH, Josh Skapin)

- According to CMHC in August developers broke ground on 388 single family homes in Calgary, up 15% YoY, and between January 1st & August 31st the number of 'new starts' was 2,834, up 33.4% YoY from the 2,124 in the same period last year.

A not dissimilar pattern is apparent in Edmonton where new homes, apartment buildings & office towers are sprouting everywhere like mushrooms after a rain despite the fact that the commercial vacancy rate is in the 18% range & rising, there are an estimated 15,000 empty apartment-, & condo-, units and StatsCan just reported that the number of people leaving for other provinces is at a 20 year high : in the year ended June 30th, 2017 70,800 Albertans left for greener pastures elsewhere (although the 55,700 newcomers reduced the net outflow to just 15,100). Worse still from a macro-economic perspective is the fact that this net outflow results in lowering the Alberta work force-, & home buying market-, quality; for those who leave typically have greater skills & earning potential than many newcomers who still mistakenly believe that in Alberta the 'streets are paved with gold'. And it does make one wonder about the financial astuteness of those driving-, & those funding-, this building mini boom (that is 'borrowing' economic activity from the future?).

FITCH IS EXPECTING CHINA'S FIRST LOCAL GOVERNMENT BOND DEFAULTS BUT TIMING UNCERTAIN (CNBC, Huileng Tan)

- It issued this warning in a Sunday September 24th press release. The US$605BN bonds in question are those of off-balance sheet LGFVs (Local Government Financing Vehicles that have also borrowed heavily from China's 'shadow banking' sector)[7] that were

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6 According to the National Bank of Canada in the decade ended December 31st, 2016 average house prices in major Canadian cities rose by between 50% & 150%.

7 Last July President Xi is said to have been really angry when the regulators reported that bank assets were in the US$38TR range (i.e. 300+% og GDP, vs. 155% In Germany, 168% in the UK & 242% in the US) and that the off-balance sheet portion thereof was equal to 110% of the on-balance sheet portion rather than 42% as he had been told earlier

created by local authorities to bypass the restrictions on their direct borrowing as the Beijing crackdown on leverage led to a drying up of funding from official channels. While to date no LGFV has defaulted on its debt, the arrival of the first default is " becoming more likely and will probably trigger a repricing of the market."

- This came in the wake of S&P earlier this month, for the first time in 18 years, having cut the credit rating of China's long-term souvereign debt from AA- to A+[8]. But according to Fitch the overall risks are likely to be limited because of the government's "pervasive ownership and influence across the financial system." And, while "the authorities continue to rely on local government investment - supported by the LGFVs - to achieve their economic/*GDP* targets, they have a broad spectrum of policy tools to limit contagion... and thus are in a position to prevent systemic defaults".

This brings up an interesting question. Local governments are under pressure to do their bit to help Beijing meets its GDP growth targets; so the local party chiefs are more interested in meeting their GDP growth obligations rather than in the RoI's of projects they plow money into. This means that in real economic terms China's impressive GDP growth numbers may at some point, when 'the chickens come home to roost', prove to have been delusionary.

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German elections - The vote count was (with the last pre-election poll results in brackets) : Angela Merkel's centre-right CDU - 33.0% (34%), Martin Schulz's centre-left SPD - 20.5% (21) , far-right AfD - 12.6% (13), pro-business FDP 10.7% (8)[9], far left Die Linke - 9.2% (11), Greens - 8.9% (8) & Other - 5.1% (4).[10] [11] [while the CDU/CSU's voter support (CSU is the CDU's Bavarian sister party[12]) is below the 37% level earlier this year[13] & an all-time low, in a PR (proportional representation) system a party with one-third voter support is always one to be reckoned with, especially when there are six parties in parliament]. SPD support is also at an all-time low & drastically down from March when, after it got a new leader, Martin Schulz, the former President of the EU Parliament, its 32% voter support had it nipping at the heels of the CDU's 33%. As to the AfD, its level of voter support[14] was way down from last January's 17% (as was the support for the ultra-right Geert Wilders in the Dutch March election?) &, despite the bluster talk by some of its leaders, it may be coming apart at the seams; thus at a press

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8 Moody'S had already done so last May.

9 A stunning comeback for the perennial third party in the Bundestag since 1949 that in the 2009 election had 14.6% voter support but in 2013 had failed to pass the 5% voter support threshold required to get any seats in it.

10 So for once the polls were close to the mark which is the more remarkable since very late in the campaign the number of those who called themselves "undecided" was 40%.

11 In other words, the two mainstream parties both lost- (CDU/CSU - 8.6% & SPD 5.2%), & the four fringe ones all gained- (AfD - 7.9%, FDP - 6.0%, Linke - 0.6% & Greens - 0.5%) voter support.

12 That is in part responsible for the CDU's poor performance; for

13 Way down from its 41.5% in 2013 but no that far off its 33.8% in 2009.

14 One quarter of the support for it originated with people who hadn't bothered to vote in 2013 because they were disenchanted with the performance of both the CDU & the SPD

conference on election night called to show strength, its co-leader Frauke Petry, the telegenic face of the party during the campaign, blew the socks of all present by announcing, before abruptly walking off the stage, that, while she will take her seat in the Bundestag, she had decided "after careful reflection ... not to sit with the AfD parliamentary group" (& there now also seems to be a split in its strong presence in the MecklenburgVorpommern, Angela Merkel's home state[15] (in both cases because of rank & file discomfort with the extremist talk of some AfD 'prominenti').

Almost immediately after the results were out, the SPD announced it would not remain in the Grand Coalition with the CDU/CSU in order to become the largest opposition party in the new Bundestag & 'deprive the AfD of that role'. This gives Chancellor Merkel few options but to seek to create an in Germany first-ever three party "Jamaican" coalition[16] with the FDP & the Greens (both of whom will take some serious convincing/bribing to join her in that venture since historically in Germany small parties talked into becoming part of a coalition have always paid dearly for that at the next election. And since Frau Merkel too is known not to be enamoured by a Jamaican coalition solution, the coalition-building phase could take considerably longer than the nearly three months it took in 2013 (& the possibility of another Grand Coalition can not yet be entirely ruled out, if only because only 23% of voters support the idea of the Jamaican solution).

At the time of writing (Monday evening GMT) there was as yet no news about the seat distribution in the new Bundestag. This is because the German election arrangements are quite convoluted. Voters all have two votes., one to cast for direct election in each of the 300 or so constituencies & the other for the 'state lists', with half the 630 seats in the Bundestag allocated to those who got outright majority support in their voting district & the other half to candidates on the parties' state lists (with things being further complicated by many candidates in the first category also being on their party's state lists, in case they failed to get a majority in their own right). Furthermore, the votes cast for the almost 30 parties that had failed to meet the 5% minimum voter support threshold have to be allocated among the six parties that did. Thus after the 2013 election the CDU got half the seats in the Bundestag with just 42% voter support. As of a September 27th preliminary seat distribution quoted by The Guardian the CDU/CSU seat count would be 246 (34.7%) vs. the SPD's 153 (21.6%), AfD's 94 (13.3%), FDP's 80 (11.3%), Linke's 69 (9.7%) & Greens' 67 (9.4%) -*I take no responsibility for these numbers since they don't seem to add up.*

Building a coalition can be a time consuming process : in Germany after the 2013 election it took 86 days (& in Belgium in 2010 a record 541 days). And while there has been much talk of Merkel's only option being the "Jamaican" variety (so named because the colours of the three parties involved, black for the CDU, gold for the FDP & green for the Greens, are those of the Jamaican national flag). But there are deep, all but irreconcilable, disagreements between the these three parties on, among others, issues related to energy taxes, Europe & immigration.

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15 During the campaign Frauke Petry had argued that the abrasive style of some AfD 'prominenti' was putting off middle class voters but had lost out to the more extremist elements of the party (one of whom went on record during the campaign as advocating it "was time for Germany to be proud of the achievements of its soldiers in two world wars" while another in a speech last January labeled the Berlin Holocaust Memorial a "Monument of Shame".

16 So called because the three parties colours (Black for the CDU, Gold for the FDP & Green for the Greens match those of the Jamaican flag.

And to complicate matters even more the CSU wing of the CDU (that has been in power in Bavaria for all but three of the last 72 years) got its head handed to it in the election, - exit polls suggested that support for it had declined to 38.5%, down from 49.3% in 2013). And it faces a state election next year & so is obsessed the possibility it could lose still more votes to the AFD (that already has representatives in 13 of Germany's 16 state parliaments). CSU leader Horst Seehofer spent much of the past two years criticizing the CDU immigration policy, its Secretary-General Andreas Scheuer told the Passauer Neue Presse, a major regional newspaper, that "The CSU has given voters guarantees and one of those is an upper limit on immigration. We must limit immigration", & being home to both Audi & BMW the CSU is opposed to anything that smells of emission controls such as are core to the Greens' thinking, while its talk of limits on immigration is anathemous to both Chancellor Merkel & the FDP. So while the SPD may have nixed the idea of another Grand Coalition, the evolution of some form thereof cannot be ruled out. And while a lot of baffle gab is emanating from the 'talking heads' on TV that Chancellor Merkel' position has been weakened by the election outcome, the fact remains that the majority of German voters (at last report, six weeks ago, 59%) believe she is doing "a good job" (*as witnessed by the fact she is commonly known as "Mutti" Merkel, a term of endearment for mother figures).*

Oliver Rakau, Oxford Economics' Chief German Economist reckons the election outcome will result in a 0.5%-1% 'easing' of Germany's GDP growth[17], an income tax cut (that relative to income will be largest for low income earners but in absolute terms of greatest benefit to high income ones) & that the new government, regardless of its make-up, will be less pre-occupied with balancing the budget (*which raises questions about the future of Walter Schaeuble, who has been Chancellor Merkel's Finance Minister for the past eight years, was a proponent of fiscal austerity (which made him unpopular in Southern Europe) & a strong advocate of the EU concept, although he was not much in favour of the greater integration ideas of Messrs Juncker & Macron) - The latest news is that he now, at age 75, has agreed to be sidelined as President of the Bundestag, as many in the CDU had been urging him for some time).*

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[17] And the longer the coalition period, the greater the deleterious impact on GDP growth.