GLEANINGS II - 730
Thursday October 5th, 2017

Quote of the week - "Come the next recession, the Fed is, at present, poorly positioned to respond with force and, most importantly, with credibility. The Fed's status will be called into question when it's needed most." Kevin Warth (from his June 24th, 2016 talk[1] "Reform or Perish" at the BIS' 15th Annual Conference in Lucerne, Switzerland in which he casts himself as someone whom the NYT's David Brooks[2] says is on the "edge of inside", i.e. someone on the edge of a management group that engages in "group think" (*for biographical detail on him see 'below the line')*.

Canada's Energy East pipeline – "After careful review of changed circumstances" TransCanada has finally given it the kiss of death. It never made economic common sense, anyway, and certainly not for Alberta producers, to haul oil 2800 miles to an already well-supplied Atlantic Basin rather than 800 miles to a Pacific Basin terminal that would supply a still growing market (although it would have been a transfer of wealth from Alberta to points East & most of all to the New Brunswick Irving family. In addition, it only made sense when it would use 50 year-old pipe with a useful life of 35 years for the first half of its journey. Finally, it would have been required to go across 180 First Nations' lands among whose chiefs there would likely have been at least one Elijah Harper 2.0.

Definition of a Canadian - An unarmed North American with health insurance.

US Tax Reform - Jim Chanos (age 59), a Yale economics & political science grad, worked for a few years on Wall Street before starting his own (short selling) New York-based hedge fund, Kynikos, in 1985 with US$16MM (today it has AUM of US$2.3BN). He 'made his bones' shorting Enron[3] before fraud drove it into bankruptcy in 2001 (in the process causing the demise of its auditor, Chicago-based Arthur Andersen, then one of the "Big Five" accounting firms). He recently told CNBC that "What many investors don't understand is that *under the latest GOP tax reform proposals* the majority of large cap companies' tax rates will actually go up" (due to the limits on the expensing of interest & the loss of tax loop holes) - *To support his thesis that 'one taxpayer's gain is another taxpayer's loss', he uses a chart produced by the BEA (the Department of Commerce's Bureau of Economic Analysis) showing that for 65 years the US government's tax "take" as a % of GDP has fluctuated in a narrow band around 19% (that also supports the case of those who believe that politics today are less about getting things done than about creating the impression they're getting done).*

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US HEALTH SECRETARY RESIGNS (Reuters, Steve Holland)

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[1] That's well worth reading & can be accessed by googling "BIS Paper 92".

[2] Who recently tweeted that "Trump isn't good at much, but ... wickedly good at sticking his thumbs in the eyes of the educated elites" (*as opposed to the moneyed ones?)*

[3] A balsy move, since for six years it had been Fortune's "America's Most Innovative Company".

- Tom Price did so on September 29th, having displeased President Trump by creating an uproar for spending US$52,000 on chartered aircraft, *rather than flying commercially*, while on government business. This leaves two vacancies in Trump's Cabinet since he has yet to fill that left in the Department of Homeland Security by his *seemingly good* move to make John Kelly White House Chief of Staff.

Price (age 62) is an MD who spearheaded Trump's so far fruitless effort to terminate Obamacare. Prior to becoming Secretary of Health, he was a member of the House for 12 years (the last two as Chairman of its Committee on the Budget) for Georgia's 6th District &, before that of the State Senate for eight. Amazing that someone so long in the public eye could be so blind to 'bad optics' & how limited Trump's loyalty is to those who do his dirty work.

TILLERSON'S LONG-SIMMERING FRUSTRATION THRUST ONTO THE PUBLIC STAGE (Politico, Eliana Johnson)

- On October 4th NBC reported that this summer (*after the Charlotteville incident & Trump's reaction thereto?*) he had nearly resigned & in talking with friends had called the President *a* "moron". This, according to a White House official, had sent the President into a rage & prompted Tillerson to call a press conference, that pre-empted other programming on the cable TV networks, to insist he had "never considered quitting" *but at which he wouldn't respond to a question about the alleged moron remark.* And by mid-afternoon the White House was in full damage control mode, with Trump declaring his "total confidence" in Tillerson & lashing out at "fake news". None of this alters the fact that, at a time of the serious foreign policy challenges posed by the Iran nuclear deal & North Korea's ICBM/nuclear ambitions (on both of which they seem to have different perspectives), the relationship between this President & his Secretary of State is the worst ever, not altogether surprisingly so since Tillerson, *recommended for the job by former Secretary of State Condoleeza Rice & former Secretary of Defense Robert Gates*, embodies the GOP establishment that Trump has long railed against &, while Trump is a bombastic media-driven New Yorker, Tillerson is a soft-spoken Texan who keeps the media at arm's length and, having grown up in Exxon's disciplined decision-making environment, chafes at having his work interfered with by the chaotic, young & inexperienced White House staff (especially *Jared Kushner?)*

Expectations are growing that early in the New Year, there will an exodus of White House staff (some of whom are known to be job-hunting) who believe that, having given it 'the old college try' for a year, enough is enough. And Tillerson changing his mind could come as soon as this month; for at mid-month (as it is required to do every three months), the State Department must certify that Iran has met all conitionalities of the seven-country nuclear deal and, while the three "adults" in his Cabinet (Messrs Mattis, McMaster & Tillerson) are advising him not to do so, the possibility of Trump pulling the US out of it cannot be ruled out.

U.S. INVESTORS SEE A CORRECTION COMING ... (BB, Suzanne Woolley)

- A Wells Fargo/Gallup poll of 1,006 households with at least US$10,000 in stocks, bonds or mutual funds showed that 54% of respondents expect a stock market decline this year that will wipe out "significant gains". Still, only 18% were selling stocks to shield their portfolio from the resultant downdraft, 20% was buying bonds to limit their stock market risk & 40% said they weren't rebalancing their portfolio.

Retail 'customers men' know that amateur investors always can see reasons not to sell 'right now" & cry loudest after the stock market train has left the station without them.

<u>GUNMAN HAD "BUMP-STOCK' DEVICE THAT COULD SPEED FIRE</u> (AP)

- The purchase of fully automatic weapons has since the 1930's been restricted in the US & in 1986 the federal National Firearms Act was amended to further prohibit the possession of machine guns by civilians. Numerous attempts to design 'retrofits' that would make semi-automatic weapons fully-automatic[4] (one that keeps fining until the magazine is empty as long as the finger holds back the trigger) failed until, a few years ago a device called a "bump stock" came on the market that Sen. Dianne Feinstein (D.-CA) has long railed against since, as she told AP several years ago, it "turns a semi-automatic rifle into a weapon that can fire at a rate of 400 to 800 rounds per minute". Stephen Paddock, the Vegas shooter, used 'bump stock' weapons in his firing spree.

Converting a semi-automatic weapon into a fully automatic can be quite easy (I was taught how to do it with the FN .762 rifle in basic training sixty years ago); the brilliance of the bump stock device is that it does so while maintaining the weapon's semi-automatic legal status.

<u>ARAMCO'S IPO IS RESHAPING SAUDI ARABIA'S OPEC POLICY</u> (Reuters, Rania Gamal)

- Last November, when Saudi Arabia wanted its fellow OPEC members to agree to a production cut, it had a unique bargaining chip in its threat to quit OPEC if they didn't.. For it wanted the price of oil to increase to the US$60-70 range[5] to hike the valuation of Aramco's IPO whereas historically it had always sought to convince OPEC's hawkish members that a too high oil price would encourage the development of alternate energy sources. This shows how the IPO, part of the young Crown Prince Mohammed's plan to modernize the Kingdom, is forcing it to rethink its policies in-, & raises questions about the future of-, OPEC. And after the IPO Saudi Arabia will be the only OPEC member whose national oil company is listed on the Riyadh-, & at least one global stock-, exchange (where membership in OPEC could make it vulnerable to charges of participating in price fixing[6]).

Crown Prince Mohammed bin Salman may be King Salman's youngest & favourite son. But over the foreseeable future that may be all he has going for him [and the King will be 82 as of January 1st & has long been rumoured to have health problems (incl. the onset of dementia?)]. So when he passes. Prince Mohammed may find he has more enemies than a dog has fleas (& the recent mass arrests suggest he is aware of this). Among the older Royals he is regarded as a young upstart who is "playing" his father & few of them relish having him lord it over them. The 'palace coup' that made him Crown Prince last June totally 'sandbagged' the incumbent, Prince

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4 The difference between the two is that with a semi-automatic weapon the shooter must actually pull the trigger for a round to be fired (without having to 'cock' the weapon each time), while fully-automatic weapons keep firing for as long as the shooter keeps pulling back the trigger.

5 Which the production cutback program a, at least so far, failed to achieve : after hitting US$59 in January, shortly after the program was launched, it cratered to US$46 in June only to recover to US$58+ last month and had slightly weakened again to US$56 at last report.

6 Thus Norway has studiously refrained from joining any output regulating steps ever since listing Statoil on the Oslo & New York stock exchanges in 2002.

Mohammed bin Nayef (age 58), a member of the family who had 'earned his spurs'. As Minister of Defense Mohammed has presided over a war in Yemen that is an unmitigated military-, PR-, & human welfare disaster. It was announced last month that the Vision 2020 reform plan, that he is in charge of implementing, would be 'overhauled' to make it more "focused" & have "clearer governance" & its target of balancing the budget by 2020 looks increasingly hallucinanatory. He upset civil servants by cutting their benefits. Inside Aramco there are strong sentiments that his listing initiative is not in the best interests of neither the company nor the country & that his production cutback scheme has cost it market share in Asia. The Qatar blockade hasn't produced the quick results expected and, worse still, has driven Qatar closer than ever to Iran & Turkey. His 'socially progressive' ideas, the latest one being the King's order that starting next June women can drive cars themselves, rather than having to be chauffeured by a male, hasn't gone over well in influential (uber-conservative) circles[7].

MR. JUNCKER'S INDIAN SUMMER[8] (Economist)

- A year ago the European Commission President, the top EU bureaucrat & once long-time Prime Minister cum Finance Minister of Luxemburg, said in his annual State of the Union address "Never before ... have I seen such little common ground between our member states ... Our European Union is, at least in part, in an existential crisis." For Britain had just voted to leave the club &, with populism on the rise all over, difficult elections loomed. But one year later the mood has changed drastically, as a result of the poor election outcome for the anti-EU parties in Holland & France, the faster EU-, than US-, growth for two years in a row, & by Brexit & Trump prompting European voters to rediscover their love for stability. And with the success of *the pro-EU* Macron in France & imminent re-election of Merkel in Germany there appears to be a window of opportunity for reform. So on September 13th, in a lengthy address[9] to the European Parliament he set out an ambitious agenda, incl. more trade deals, beefed-up cyber-security & expansion in the Western Balkans &, instead of pleading for help in dealing with migrants, praised the border guards, & Italy for slashing migration from Libya, while his talk of "a Europe that protects" sought to erode the appeal of Euroscepticism. And Brexit hardly got any mention; for he believes it will let the EU get back on its 'natural path'. He is making two bets : that greater integration can be achieved by stealth, i.e. without having to go through the hassle of summits, *parliamentary approvals* or referenda (*that he knows he would lose?*) & that he can somehow circumvent the deep intra-Europe divides over migration, money & the rule of law that he lamented last year *& that have long frustrated the Eurocrats.*

The Economist aptly describes Juncker as an "aging Europhile". He has all his career been 'on the tax payers' dime' &, like professional politicians & bureaucrats everywhere, looks upon government (& the EU) as an end in itself, not a means to an end. And now he cannot accept the reality that the recent top-driven headlong EU expansion has created a monster that's out of Eurocrats' control.

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7 A 20 year-old Saudi man was recently arrested for tweeting that "if a saw a woman behind the wheel of a car that was broken down, I would 'burn here and her car' ".

8 A period of unseasonably warm autumn weather in the Northern Hemisphere, typically after the first snowfall.

9 After which he refused to answer questions, claiming to 'feel unwell'.

<u>CHINESE CREDITORS FIND EVEN STATE-BACKED CREDIT PROTECTION HAS ITS LIMITS</u> (Reuters, Shu Zhang)

- Two years ago China's second-largest loan guarantor, state-backed Hebei Financing Investment Group (HFIG) collapsed; ever since its creditors have been stonewalled by its shareholders, the Hebei provincial government & SACAC[10]. The two sides don't even agree on how how much it owes : HFIG says 32BN yuan (US$4.83BN) & the creditors 60BN yuan (US$9.06BN). Its collapse shows that the financial protection of the *Chinese* state has its limits & that 'state-backed' doesn't necessarily means restitution for '*stiffed*' creditors; for other factors come into play, incl. the local government's fiscal situation & its reliance on the debtor companies for tax revenues & local employment, and on whether the central government gets directly involved; for the courts typically won't hear such cases & push the creditors back to seeking redress from the debtor(s).
- HFIG was set up to support the private sector, a key investor & employer, since the state-dominated banking sector viewed private firms as undue credit risks (so today there are as many as 7,000 credit guarantors, one-third of them state-owned, that between them, as of the end of 2016, had guaranteed US$2.2TR of third party debt[11]). It collapsed after the region's growth had slumped in 2016 to 6.5% from 11% in 2011 &, having not anticipated this, thousands of firms defaulted on their loans. So, as defaults piled up & creditors started looking at HGIF for repayment; it simply stopped honouring its pledges to them, creating havoc so widespread that in October 2015 the CEO of a Beijing-based asset management firm was stabbed by an investor who had lost money in the HFIG affair. And a year later, when a group of creditors, incl. a state-owned bank, *took the bull by the horns* & traveled to Hebei Province to put HGIF's feet to the fire, no one showed up at their first three scheduled meetings, while at the fourth the only one there, a local SACAC office official, told them "We don't have the right or administrative authority to help collect your debts ... for your contracts were not signed with SACAC (*the majority HFIG shareholder*), Right?*"*
- Earlier this year the BIS warned China was headed for a banking crisis & in August the IMF called its debt levels "dangerous" even as Beijing was enforcing a policy of debt reduction. According to the China Chengxin International Credit Rating Company there were no SOE defaults in 2014 but 28 in 2016 (involving19BN yuan/US$2.07BN). And bonds are only a part of the picture since most credit has been in the form of loans from *state-owned* banks. According to Ying Wang, Fitch's Senior Director of Asia-Pacific corporate coverage, a state default is a more tangled affair than a private bankruptcy since there are *typically* other state entities involved with different willingnesses to support other SOEs (State-Owned Enterprises). So "The sanctity of (*China's?*) state debt as risk-free is being eroded ... The idea has definitely changed as investors have seen (*learnt?*) in cases of SOE defaults."

Since the slowdown in growth in Hebei province was in line with that in the nation's overall GDP growth rate, the HFIG debacle likely is repeated in many, if not all, other provinces. And since during the 'boom years', the provincial governments were more interested in generating local

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[10] State-owned Assets Supervision and Administration Company (an entity that reports directly to the State Council, China's chief administrative authority headed by the Premier), that at last report was responsible for the management of well over 100 SOEs with assets of US$1.5+TR])

[11] While that may seem like a lot, it's only about 20% of GDP & <10% of total debt.

growth numbers that made them look good in Beijing's eyes than in the economics of the projects they funded, China's banking system's denouement will likely be aggravated by these projects' inability to make a contribution to growth in the years ahead. And the looming financial crisis may well turn out to be far more systemic than even the BIS & IMF have imputed; for the above suggests the Chinese financial system is a mountain of houses of cards[12] [13] *built on a credit the credibility of which is being allowed to erode. The interesting part about the Hebei Financing debacle is that it is playing out right underneath the Beijing officialdom's noses; for the province surrounds the city on three sides. And the situation is not going to be helped by the fact that, while President Xi when he first came to power five years ago bravely talked about the need to restructure the SOE sector, lately that idea seems to have been subordinated in his mind by the need for it the help implement Party control over the economy.*

<u>RUSSIA'S LATEST GAME ; CHALLENGING NATO AT SEA</u> (BB, Editorial Board)

- In the *14 to 20 September* <u>Zapad</u> war games in Belarus & Kaliningrad (the pre-WW II East Prussia that is sandwiched between Lithuania & Poland on the Baltic Sea), *the largest since the end of the Cold War twenty-five years ago,* 100, 000 Russian troops defended Russia against, & beat, the fictional country of <u>Veyshnoria</u>. While most of the action took place on land, it also involved Russia's Baltic fleet (of destroyers & submarines) as well as a major naval force in the Arctic Ocean off NATO member Norway's North coast. While the possibility of an invasion of the now NATO member Baltic states, that but once an integral part of the Soviet-, & before WW I of the Czarist-, empires, may be unlikely[14], the possibility of a 'hybrid war', such as Russia conducted with success in Crimea & Eastern Ukraine, that in this case could involve submarines cutting seabed communication-, & power-, lines, surface ships launching cyber attacks and blockades & generally interfering with seaborne trade, & landings on isolated but strategically important Swedish of Finnish islands.
- In response to Russia's *more* aggressive stance in the Baltics NATO should establish a bigger & higher level presence in the Baltic states & the US Navy should upgrade its presence in the Baltic Sea from the occasional visit by a few destroyers to an ongoing major presence such as it now in the South China Sea (*and it has long had in the Middle East*). And NATO should be restructured to give the NATO Supreme Commander more authority & flexibility to enable him to respond quicker in crisis situation, & strengthen its relationship with the NATO non-members (Finland & Sweden) that are vulnerable to Russian aggression, possibly by negotiating agreements that would enable it to quickly respond to crises engendered by Russia.

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12 And reinforces my sense that the whole China phenomenon is little more than a Potemkin Village, all front but no substance behind & that the likes of President XI are well aware of this but sort of operate on the basis of John Maynard Keynes' maxim that "If you owe your bank a hundred pounds, you have a problem. But if you owe it a million, it has". Hence its rush to invest in real assets abroad.

13 While during the decade ended in 2014 the SOE sector's share of the nation's fixed asset investment declined from almost 60% to 30% of tha national total, since then it has increased to nearly 40%, while since 2008 the debt/equity ration of SOEs has risen from 140% to 160% while that for non-state-controlled firms ahs declined from 140% to about 115%.

14 But not that unlikely since in both Estonia & Latvia, one-quarter of the population consists of ethnic Russians, many of them former members of the Soviet armed forces, who stayed there after their time was up or their families, who at some point may need "protecting".

Putin risks falling in the same trap as Breshnev, that of engaging in an arms' race with the United States that the Russian economy cannot sustain, especially now that the price of oil is little more than half of what it was when his Economy Minister in early 2014, i.e. before the oil price collapse, advised him that his ambitious plans would require 5% annual GDP growth (whereas in 2014 it was 0.7%, in 2015 -2.8%, in 2016 -0.2%, & in the last three quarters 0.3%, 0.5% & 2.5% annualized ,

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Terrorist attack in Edmonton? - At about 2200 hrs Saturday night the air outside my apartment was suddenly rent by the sound of a multitude of police sirens & the police helicopter started circling overhead with its search light glaring. For a couple hours earlier a police officer directing traffic outside the football stadium, as a game was in progress inside, was run down by a car & thrown several feet in the air, after which the driver got out &, before fleeing on foot, stabbed him as he lay on the ground. Identification of the doer was easy for the car was his own. So the police threw up a dragnet that a couple hours later stopped a rental truck driven by the doer. A high speed, forty block chase ensued down Jasper Avenue, Edmonton's main drag, involving as many as ten police cars, during which the doer ran down four more people in cross walks before the police cornered his vehicle & rolled it on its side using a "police car manoeuvre" & arrested the doer without gunfire a couple of blocks from where I was sitting in my living room. The police officer & two of the other victims were released from hospital that same night while at last report the remaining two victims were still in hospital with non life-threatening injuries. The culprit was a 30 year-old Somali refugee 'known to the police' since it had investigated him a couple years ago after he had been reported to be 'spreading extremist ideologies'; so this drama is categorized as a "terrorist incident".

Kevin Warth (age 47) met with Trump & Treasury Secretary Steven Mnuchin in the context of their review of candidates for the Fed Chair's job, should Trump decide not to renew Janet Yellen's mandate or in the by no means unlikely event that she chooses to retire. Warsh is held to lead the pack of half a dozen or so probables as Gary Cohn's star has dimmed in Trump's eyes, and would appeal to Trump because a) he's rich (Forbes estimate of his Net Worth is US$2BN, which presumably does not include the US$2.1BN-worth of Estee Lauder shares his wife, Jane Lauder owns) & b) is the son-in-law of Ronald Lauder (of Estee Lauder fame), an old friend of Trump's[15], and in July was the co-author (with Columbia's Glen Hubbard, and Stanford's John Cogan & John Taylor[16]) that postulated that the Trump tax-, & regulatory-, reform plans would raise the US GDP growth rate to the 3% level . He spent the early years of his career at Morgan Stanley before becoming Special Assistant for Economic Policy to Bush 43 who was sufficiently impressed with him to nominate him for the Fed Board in 2006, raising some eye brows, in part because of his age, he was only 35 (that with the benefit of hindsight seemed justified since in 2007, one year before the Lehman collapse, he opined that "financial innovation had made the system stronger"). During his five years on the FRB he served as its

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15 He is deemed far more 'hawkish' than the dovish Yellen. And he has been critical of the Fed's policy stance, having gone on record a year ago on CNBC's Squawk Box program that "It is not obvious what their strategy is ... they say they're data dependent ... *but* they look to me asset price dependent, more than they look data dependent ... *and* give the impression policy makers care more about not tanking asset prices than reacting to economic conditions ... The Fed had a long window to tighten policy and raise rates - in 2013, 2014 and [most of] 2015 ... it strikes me they missed that wide-open window."

16 Both Hubbard & Taylor are on everybody's short list, albeit with longer odds than Warsh, of possible successors to Janet Yellen.

‘point man’ with Wall Street & came to be well regarded by Bernanke but in 2011 he resigned. In recent years he has been a Distinguished Visiting Fellow at Stanford & a member of the Group of Thirty (a Washington-based group of financiers & academics that aims at ‘deepening understanding of economic & financial issues & examining their consequences’). Founded in 1978, at the behest of the Rockefeller Foundation, by the now 78 year-old-, & still the Group’s Executive Secretary, Geoffrey Bell when, after service at, among others, the UK Treasury & as Economic Adviser at the UK Embassy in Washington, he was Assistant to the then Chairman of Schroder’s Bank, & subsequently Governor of the Bank of England, Gordon Richardson. The Group is currently chaired by Singapore’s Deputy Prime Minister & its current membership includes Chairman Emeritus Paul Volcker[17], Ben Bernanke, the New York Fed’s William Dudley, Kenneth Rogoff, Larry Summers & Paul Krugman as well as, among others, the current and/or past governors of the ECB & of the central banks of England, Mexico, Japan, India & China , and the Chairman of UBS & the General Manager of the BIS. If Warsh were to be Trump’s choice, he would be the first Fed Chairman since Paul Volcker[18] three decades ago not to have a Ph.D. in economics (his doctorate is from Harvard Law); so it might be an inspired choice to have someone with financial “street smarts” who made a bundle by taking advantage of the system’s weakness running a central bank that for decades has been dominated by ‘pointy-headed’ academics with Ph. Ds & security of tenure [there is an old (14th century?) English saying that “a poacher makes the best game keeper” (since he has first hand experience with all the ‘tricks of the trade’)].

17 Who in 2010, at age 82, ‘eloped’ with his long-time assistant Anke Dening.

18 Volcker while at LSE in the early 1950's chose not to pursue a doctoral program.