Quote of the week : “A nation without a rational government is in my opinion an awful spectacle” -
Alexander Hamilton (a Founding Father & the United States’ first Secretary of the Treasury).

Last May Fed Chairman Bernanke started publicly musing about “tapering” its purchases of UST & MBS securities, only to “blink” at the September FOMC meeting & decide the ‘Goldilocks moment’ hadn’t arrived yet. While the market continues to speculate as to when he may think it might (& generally seems to think in terms of December or January), it overlooks three salient facts. First, any decision to start tapering was always said to be ‘data-sensitive’, i.e. dependent on the Fed’s reading of the US economy’s tea leaves/chicken’s entrails (obviously last month’s weren’t favourable enough yet, & they haven’t gotten any better since). Secondly, it would be most surprising if it were to come to a different conclusion during the next several months of uncertainty with respect to the budget & the debt ceiling. Thirdly, incoming Fed Chairman Janet Yellen is even more of a ‘dove’ than Bernanke & therefore likely to have an even more negative bias built into her interpretation of the latest economic date at future potential tapering decision points. And finally, if a tapering decision is delayed until next year, it is likely to be come become increasingly unlikely and/or modest in size with the passing of each day closer to the midterm elections.

Anyone who **seriously** believes that postponing decisions on the budget & the debt ceiling **will** result in solutions is an optimist. While one must hope it will result in solutions, the risk is very real that it will just cause the same blinkered people who caused the latest crisis to dig themselves in deeper. While democracy is all about implementing the wishes of the majority while protecting, to the greatest extent possible, the rights of the minority, what the world witnessed in recent weeks in Washington was a tyranny of a minority that responsible leaders, in this case first & foremost House Speaker John Boehner, didn’t have the balls to squelch. Thus the Seattle Times on October 6th commented on his recent performance as follows “You could look far and deep in U.S. history and not likely find a national crisis precipitated and maintained so exclusively by a single politician’s pathetic, unbreakable suction to the teat of titular grandeur” (*this was before he so pathetically allowed a bill that conceded very little to be passed in the House by the same combo of virtually all Democrats & less than half the Republicans that, had he allowed it to do so three weeks earlier would have been passed then & avoided the whole ensuing US global image-destroying mess.*

The “TED spread” represents the difference between the rate of interest that banks & the US government pay to borrow short term. Ever since it started to be tracked years ago, it has been positive since short-term lending to the US government was by definition risk-free while lending to banks always entails some risk, no matter how solid the bank. But on October 7th the rate went negative, thereby seemingly suggesting a market perception, for the time being at least, that banks were a safer bet than the US government. *Sic transit gloria!*

A view often heard expressed in the more insular parts of the US financial & political communities is that there is no need to worry about foreign investors pulling out of the UST market; for, thus goes the reasoning, they have no choice since it is the biggest & most liquid in the world. This view ignores several relevant factors. The US dollar’s role as **the** currency of denomination in global trade is being eroded which over time will reduce the need for foreigners, incl. foreign central banks, to maintain US dollar working capital/cash balances. While liquidity is always important, at the margins there are limits to its desirability. There is a vast difference between‘stocks’ & ‘flows’; so while this may be possibly be true for foreign investors’ current holdings of UST securities (i.e. the “stock”, it is less relevant to their decision-making with respect to the investment of their potential incremental US$ exposure (the “flow”).

Thirdly, investing in UST securities in recent years has not been an altogether happy experience income wise (& is likely to generate losses of capital from one of, or a combination of both, higher US interest rates and/or a weaker US dollar in the not too distant future). Fourthly, with its population aging & starting to disgorge some of its holdings of JGBs, Japan, the second largest foreign holder of UST securities, may be soon be forced to follow suit & start unloading some of its holdings thereof. Fifthly, it ignores the fact that the process of UST disinvestment has already started, as witnessed by many central banks' gold purchases & Beijing's rush to use its dollar hoard to fund development projects in other emerging economies (to the point where its role in net new international development funding now exceeds that of the World Bank) & to purchase "hard" assets worldwide wherever it can. And last, but not least, David Li Daokui, a member of the monetary policy committee of the People's Bank of China (i.e. its central bank), recently authored an article in the Financial Times advocating Beijing should 'cut back its lending to Washington' [1].

JPMorgan had a great Third Quarter, its Earnings per Share (EPS) were US$1.42, more than one-fifths higher than expected. But there was a hitch ... its legal costs during the quarter of defending itself against charges levied by various regulators & aggrieved parties was so horrendous as to turn that into a negative US$0.17 after legal expenses[2].

A few weeks ago the once-mighty city of Detroit went bust. On October 10th 43 year-old Kwame Kilpatrick, its mayor from 2002 to 2008, was given a 28 year sentence on two dozen charges of racketeering, extortion and enriching himself & others by fixing city contracts, bribes & kickbacks - *while not solely responsible for the city's problems, he definitely was a contributing factor.*

San Francisco-based ShadowStats uses yesteryear's methodologies for measuring current key economic data, like inflation & unemployment, on the assumption that over time the authorities have 'tweaked' the methodologies used to make things looking rosier than they really are. Thus on the pre-1980 basis for calculating the rate of inflation it is now 9%, rather than the current officially reported 1.5%. And looking at the chart, while for the first ten years after the basis for calculating the CPI was 'adjusted' in the early 80's, the spread between the rates produced by the old & new methodologies had been modest, since 1992 it has steadily widened, while following a similar up & down trend path. Ditto for the unemployment rate : while the official number shows a decline from almost 10% in late 2009 to about 7.6% at last report, the ShadowStats number shows a steady, albeit modest, increase in unemployment from the 10% level since then (*one key difference being that its calculation of the unemployment rate is based on the* ***total*** *labour force rather than just on those who actually have a job & those who are actively looking for one.*

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1 Now about age 50, he graduated in 1985 from Beijing's Tsinghua University, a top drawer university in both local & global terms. Then he went to Harvard where he got a Ph.D. in 1992, after which he taught at the University of Michigan Ann Harbour from 1992 until 1999 (with a part-time 'gig' at Stanford) & at the Hongkong University of Science & Technology until 2004, before returning, in 2005, to teach at his alma mater (since during his foreign residence the one-child policy did not apply to him, he has two children).

2 It is rather telling that one bank analyst, after waxing euphoric about how "lean & mean" Morgan Stanley had become in the past five years, had the gall to refer to money in vested in JPMorgan as "dead money".

Last week the UK Chancellor of the Exchequer, George Osborne was in Beijing, a breakthrough since the Cameron government had been in Beijing's 'penalty box' for a couple of years ever since Prime Minister Cameron had the temerity to have a formal one-on-one with the Dalai Lama. While being upstaged by London Mayor Boris Johnson, who was leading a trade mission to China at the same time, at an event at Peking University attended by both where Osborne spoke but all questions but one in the subsequent Q&A session were addressed to Johnson, & by having him trump the Chancellor's revelation his 10 year-old daughter was learning Mandarin by letting it be known **his** 16 year-old daughter was coming to Beijing shortly to pursue her studies, it was a mutually beneficial visit for both governments. For Osborne first announced a new visa system that will make it easier for Chinese citizens to visit the UK & later that Chinese companies will be given more scope to invest in the UK (which is expected to open the door for France's EDF to proceed with the the building of the £14BN Hinkley C nuclear power station in Somerset by cutting a deal with one of the three Chinese companies which it has been trying to convince to become its partner in it & share the cost thereof (the country desperately needs new power generating capacity since the shutdown of older plants & the slow progress made in building new ones is said to be stretching its power generating capacity "to its limits" with a real possibility of "serious stress" in two years' time. In return it was announced that the Industrial & Commercial Bank of China (ICBC) will shortly launch the first-ever yuan-denominated bond issue in London (which will help solidify the lead in yuan-based financial transactions over other non-Chinese financial centres it has been trying to build) & that it will be made easier for London-based investors to buy Chinese stocks, bonds & money market paper.

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BUFFETT SPEAKS OUT AGAINST DC's "EXTREME IDIOCY" (CNBC, Matthew Belvedere)

- On October 3rd the CEOs of a number of major financial institutions met with the President to warn him of the adverse consequences if government agencies remained closed & lawmakers were to fail to raise the debt ceiling by mid-October. Later that same day Warren Buffett on CNBC's Squawkbox program predicted the Republicans will, at the very last moment, have a "counterrevelation" & that while "right up to the point of extreme idiocy", they won't cross it. And he said that if the October 17th deadline is breached "one second ... that will not do us in. If it goes a year beyond it, that would be unbelievable."

Australia's most authoritative newspaper, The Australian, summed up the thinking in much of the rest of the world in its Monday October 14th editorial : "It's hard not to believe lunatics have taken charge of the asylum in Washington ... America is diminished by the stand-off." (as evidenced subsequently by Beijing issuing a call for a new,'de-Americanized' world order).

THE IMF STRONGLY SUGGESTS COUTRIES TAX THE RICH TO FIX DEFICIT (AF-P)

•It set off shockwaves in Washington at last week G-20 Finance Ministers' cum IMF fall meeting, *events that on the whole were overshadowed by the budget cum debt ceiling impasse*, by suggesting countries fight their budget deficits by raising taxes despite the fact that, as the world's guardian of fiscal orthodoxy, it has historically typically called for nations in financial difficulty to slash public spending as the better way to reduce deficits. For in its latest *semi-annual* Fiscal Monitor Report[3] entitled "Taxing Times" it posited

[3] that analyses how well its members are doing in their fiscal management.

taxing the highest income people on their assets to reinforce the legitimacy of spending cuts & fight growing income inequality. Noting the "steep cuts" in top rates *of taxation* since the 1980's, it wrote "Scope seems to exist in many advanced economies to raise more revenue from the top of the income distribution", estimating that returning tax rates on high net worth individuals to 1980's levels would produce revenue of 0.25% of GDP in developed countries (& in some cases, such as the US, could be "far more significant", i.e. as much as 1.50%). *Not surprisingly,* the OECD welcomed the IMF now sharing its view; for it is leading the global charge against tax havens & tax evasion by multinationals *ordered by the G-20*[4].

IMF's current Managing Director is a French lawyer & former French Finance Minister who presided over her country's fiscal affairs when its debt-to-GDP ratio skyrocketed from 68.2% to 82.4% in three years & whose successor once removed in France's current Socialist government was stymied in his efforts to 'tax the rich' when the courts ruled such a move unconstitutional.

<u>IMF LAYS GROUNDWORK FOR GLOBAL WEALTH CONFISCATION</u> (Forbes, Bill Frezza)

- In its recent *semi-annual* fiscal monitoring report it paints a dire picture for advanced economies with high debts that fail to aggressively "mobilize domestic revenue" (*i.e.'raise taxes'*). More specifically it says that "The sharp deterioration of the public finances in many countries has revived interest in a 'capital levy' - a one-off tax on private wealth ... to restore debt sustainability ... The conditions for success are strong, but ... need to be weighed against the risks of the alternatives, which include repudiating public debt or inflating it away." More specifically, on page 49 the report says that to bring back the debt ratio in the Euro area countries to pre-2009 levels would take a 10% tax on *all* households with positive net worth. There are three things worth noting. First, it would need to affect not just 'the rich' but any household with net worth. Secondly, it would not pay off the debt, just return 'debt sustainability'. And finally, if politicians don't have the stomach to reform the Ponzi scheme entitlement programs, the alternative will be debt repudiation and/or hyperinflation.

The two items above represent an interesting contrast in coverage between the press agency of centuries-long 'dirigiste' France & a Boston-based, part-time columnist cum successful full-time venture capitalist in the hi-tech area who is a Fellow at the Washington-based libertarian <u>Competitive Enterprise Institute</u> (that advocates "Free Markets and Limited Government"). Nevertheless, the reality of life is that such a one-time tax might be the lesser of a whole bunch of evils, if it were to bring country's debt levels back into a more sustainable range (although the numbers being thrown around as to its proceeds seem far from convincing that such a tax would be successful in doing so). But it would only be worth it if the lawmakers were to use the resultant respite productively by getting their fiscal house in order, which might be too much to expect : those in financial trouble due to bad management always believe more money will solve their problems while in reality, if their management inadequacies are not addressed, more money will just lead to a still greater mess down the road..

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[4] which is, of course, to a large extent as phoney as they come; for, while tax cheats, or rather income-, or wealth-, cheats are, of course, legitimate targets, the definition of "tax evasion" used includes multinationals who are playing by the, often inept, rules set by the very same legislators who now denounce the result of their own efforts.

<u>DEFAULT DOUBTERS REPUDIATED BY REPUBLICAN ECONOMISTS</u> (BB, Rick Miller)

- Glenn Hubbard, Douglas Holtz-Eakin & Donald Marron are economists affiliated with the Republican Party. All three served in George Bush's Administration & all three are less sanguine about hitting the debt limit than the Republican lawmakers who downplay its significance & argue the US can continue to meet interest payments on its debt even if it cannot borrow. Thus Rep. Ted Yoho (R - Fla) said in an October 8th interview "The country will not default if we don't raise the debt ceiling ... We've got enough revenue coming in to pay our bills" and Sen. Rand Paul (R - Ky) that the U.S. takes in US$250BN a month while interest is only US$20BN; so "If you don't raise your debt ceiling, all you're saying is we're going to balance the budget ... I think if you propose it that way the bulk of the American public would say 'My goodness, that sounds like a pretty reasonable idea'."
- Hubbard, who headed Bush' Council of Economic Advisers (CEA) from 2001 until 2003, *& now is the Dean of Columbia University's School of Business*, noted "It signals that we have an inability as a nation to get our budget process in order ... (which could) do damage to U.S. growth and credibility", Holtz-Eakin, who worked with Hubbard at the CEA & a former Director of the *non-partisan* Congressional Budget Office (CBO) and now heads the American Action Forum, a centre-right policy institute, that "Breaching the debt limit is a very bad idea ... While I don't know exactly what would happen, I don't want to find out" (although he does agree with other Republicans that, if Obama doesn't negotiate a deal "he's going to be responsible for the meltdown", and Donald Marron, who was at the CEA in 2008 & 2009 & now is Director of Economic Policy Initiatives at the Washington-based <u>Urban Institute</u>, that "If the government has to suddenly move to a balanced budget for an extended period, the US economy would ... plunge into recession."

Sen. Paul may underestimate the basic common sense of "the bulk of the American public."

<u>U.S. WELCOMES IRAN'S NUCLEAR PROPOSAL</u> (G&M, Patrick Martin)

- The two days *of* negotiations in Geneva between Iran & a group of P5 + 1 world powers (US, Russia, China, France, Britain & Germany) on its nuclear program & failure to comply with the Nuclear Non-Proliferation Treaty seem to have gone well. For Iranian Foreign Minister Mohammad Javad Zarif told some reporters "We hope that this is the beginning of a new phase in our relations" & White House spokesman Jay Carney others that President Obama welcomed Iran's Geneva initiative since "(*It*) ... is a new proposal with a level of seriousness and substance ... we had not seen before", and the parties involved agreed to meet again in three weeks. For while Iran is still not willing to renounce its right to enrich uranium, it does seem willing to accept increased inspection of its nuclear facilities, incl. surprise ones, & to negotiate the form, size & level of its uranium enrichment.

Meanwhile Prime Minister Netanyahu keeps beating a drum of 'it's all a charm offensive and continuation of its old 3D (Denial, Deception & Delay) strategy' that few people outside his own country pay attention to. In so doing he displayed his ignorance & undermined his credibility on October 6th when he told the BBC Persian news service "if they (i.e. the Iranians) had freedom, they would wear jeans, listen to Western music and have free elections", comments that prompted a flooding of the airwaves & digital media with pictures of Iranians doing what he had intimated they cannot, i.e. wear jeans & listen to Western music.

<u>MORGAN STANLEY SEE GOLD LOWER IN 2014 AS GOLDMAN SAYS SELL</u> (Bloomberg)

- In its quarterly metals report, made public October 7th, it says the gold price will average US$1,313 in 2014, down from its forecast of US$1,420 for this year (thereby adding to bearish calls by Goldman & Credit Suisse, with Jeffrey Currie, the former's Head of Commodities Trading calling it a "slam dunk" sale). Investors YTD have sold 712 tonnes of gold out of ETFs (*almost exactly matching the amount China imported via Hongkong*) whose assets are down 27% YTD after climbing in every one of the last ten years. Part of Morgan Stanley's reason is that "tapering has been postponed not cancelled and is expected by yearend."

Banks' gold price recommendations have become suspect since having been shown, especially in the case of Goldman, to seemingly have targeted the creation of positioning opportunities (i.e. lowballing the outlook when it wished to "go long gold", & vice versa). Meanwhile, the gold market was roiled, & traders were puzzled, when at 4:00 a.m. on October 17th six huge buy orders, for a total of almost 1.8 MM ounces of gold, worth well over US$2BN, hit the market, driving the price up 3% (to over US$1,310) in just ten minutes (with it having stayed pretty steadily in the US$1,310- US$1,320 range since). While there have been a number such 'early dawn raids' in recent months, they have always been on the sell side & attributed to central bank connivery to drive down its price (if it hadn't been for the fact there were six separate orders, one would almost think that someone hit the wrong, BUY rather than SELL, button).

<u>IN REMOTE FIELD, NORTH DAKOTA SUFFERS FIRST BIG OIL SPILL</u> (Reuters)

- A farmer discovered it in one of his fields on September 29th 14 kms. East of Tioga, ND. While the pipeline's owner, Tesoro Petroleum, initially reported it as a 1,000 bbl. spill, it was subsequently rated as a 20,600 bbl spill, ranking it among the bigger onshore US oil spills in recent years. The good thing was that, according to the authorities, there were no surface bodies of water within five miles of the three hectare spill site.

Since it was only a six inch diameter pipeline, it must have been spilling oil for days before it was discovered.

<u>LOSING FAITH IN THE NUMBERS</u> (G&M, Todd Hirsch)

- Audiences these days display a growing lack of faith in Statistics Canada's numbers. And the skeptics have a point. For, while since August 2008 the prices in its all-items basket of consumer goods & services have risen just 6.5%, broken down into its components, it is readily evident that, while the prices for discretionary items have been stable, or falling, those for non-discretionary items (i.e. the necessities of life) have taken off. Thus child care is now 21.1% more costly, public transit 17.5%, fresh vegetables 16.3%, baked goods 15.2% & food generally 14.3%. On the other hand, the price of home entertainment equipment declined 27.1%, women's clothing 13.6%, furniture 3.8% and freezers & refrigerators 1.5%, while that of cars has hardly was up only 0.2%. And shelter-wise rents were up 7% while home owners benefitted from 38.6% lower natural gas home heating costs. What's more, these price changes are reinforcing the effect of the *much talked-about* growing income inequality since, *by definition*, the less well-off spend more of their disposable income on non-discretionary items than those better-off.

The writer is Chief Economist at Alberta Treasury Branches, the Government of Alberta-owned retail banking institution whose typical rural clientele is likely to be more suspicious of *government than the average Canadian urban dweller. Still, the facts speak for themselves & confirm what anyone in charge of a household budget has long suspected, & undermine government credibility.*

JAPANESE BANKS TO PUT SQUEEZE ON GANGSTERS (FT, Ben McLanahan)

- In the aftermath of a scandal that saw Mizuho, Japan's second largest financial entity by assets, admitting it had been funding Yakuza activities through one of its subsidiaries. Japan's top banking lobby, fed up with members of Yakuza, Japan's powerful crime syndicate, walking away from their loans after making only one or two payments, just enough to avoid criminal prosecution for non-payment, announced banks will start feeding the police information about their financial affairs in the hope of squeezing them.

All one can say is : "Good Luck"; for unpleasant things can happen to those who queer a Yakuza member's pitch. It supposedly has 100,000+ members worldwide to the point where, a few years ago, a CIA operative in Tokyo was rumoured to have arranged a liver transplant in the US for a very senior Yakuza member in exchange for information about its operation in the US (it supposedly has operations in, among others, New York, Chicago & Denver).

IRELAND TO EXIT BAILOUT IN DECEMBER (BBCNews)

- Prime Minister Enda Kenny told his Fine Gael Party conference on October 12th the country is on track to exit its international bailout program by mid-December & that, while there still may be "fragile times" ahead, the "economic emergency will be over". Furthermore, that the country's huge sacrifices are starting to pay off, with S&P last July having upgraded the outlook for its BBB+ rating from "stable" to "positive" &, before that, its EU lenders having rewarded the country's sacrifices by extending its loan repayment terms. While the next budget will still feature another 2½ BN Euros in tax hikes & spending cuts, this is expected to result in next year's 4.8% budget deficit being well ahead of the 5.1% target.

Ireland always had two things going for it : it went into the tank first & its people, unlike their Continental counterparts, took the medicine stoically, albeit not happily (its first post-crisis budget was the smallest in six years). In April, when S&P announced its upgrade, First Quarter GDP growth had just come in negative (even though unemployment was declining & house prices stabilizing); but this hadn't stopped it from saying that, unlike Greece & Portugal, it expected the Irish economy to start growing at a 2% annual clip within the foreseeable future & its debt-to-GDP ratio to decline from the current 122% to 112% by 2016. The market seems to agree; for when Ireland tapped the international capital markets last spring for the first time in years with a 5BN Euro 10-year syndicated loan, its final pricing was 10 bps better than expected. The Irish experience illustrates one of the drawbacks of membership in the Euro area; for when the biomass hit the fan & the Irish banks were in trouble, the Irish government was pressured to bail them, and indirectly & more importantly for Berlin & Paris, the two Euro area heavyweights, the German & French banks, out whereas Iceland, as a non-member, could tell the British & Dutch governments, who had borne the initial cost of reimbursing their citizens for money lost in Iceland's banks, to get stuffed.

WORLD BANK UNDERGOES NECESSARY SURGERY (Reuters)

- Its medically-trained US boss, Jim Yong Kim, is targeting US$400MM (8%) in operating costs savings by eliminating layers of bureaucracy among its 10,000 staff members &

breaking up their balkanization into units that seldom interact (both of which slow the lending process). For 'fighting poverty' is an increasingly competitive business *& the Bank is losing its once pre-eminent place in the field, in part because the loans by others have fewer conditions attached to them (and in part also because the other lenders represent governments that use their unwanted surplus dollars to gain influence & markets, and captive sources of supply of strategic commodities elsewhere?*). China is heavy into lending to African countries & Brazil's BNDES[5] last year loaned US$80BBN, over twice the World Bank's volume (which, in addition, is a **gross** number that overstates its net lending impact by a factor of about 2). Nevertheless, the Bank still has a role to play since it can bring expertise to a project that few other lenders can match & insist on safeguards that reduce the risk of corruption & environmental damage.

Unfortunately, the latter, while important to Westerners, often are of no concern to, if not outright unpopular with, some of the recipient governments. Be that as it may, a restructuring of the World Bank is decades overdue since its staff has become one of the biggest beneficiaries of its existence. And any such restructuring will only succeed if he is prepared to employ Herculean Augean Stables-type methods; for the bureaucrats have always been successful in perverting similar efforts by some of his equally well-intentioned predecessors.

5 Some of Brazil's Development Bank's lending has actually been funded with money borrowed on international capital markets. And its outstandings have grown so much that it has been making noises that it wants to slow down its foreign lending.