Quote of the week : “Bombing the militants will halt their expansion, but will not wipe them out” - Mark Thompson (Time Magazine - *what they will do, & are already doing, is to follow Mao Tse-tung’s dictum that “Guerillas must move among the people like fish in the sea*”, *in which case it will take far nimbler footwork than our side has displayed to date to deal with them decisively & not cause our side to lose the war for the hearts & minds).*

In June Mohamed El-Erian, the highly-regarded former CEO & Co-CIO of PIMCO[1] & now Chief Economic Adviser to its parent, Munich-based Allianz, wrote “In their efforts to promote growth and jobs, central banks are trading the possibility of immediate economic gains for a growing risk of financial instability later” while Fed Chairman Janet Yellen on July 2nd, *in her 2014 Michael Camdessus Central Banking lecture at the IMF,* said, *among others*, that “Because a resilient financial system can withstand unexpected developments identification of bubbles is less critical” (*than what?*) - *three questions : how resilient did the financial system prove to be six years ago when it took a huge government bailout to keep it from imploding & how much has it **really** improved since, and who might have more credibility in real world financial matters, a money manager who daily stuck his neck out, & did well, or an academic with a guaranteed annual income & pension arrangements, no matter what* (*or as the old adage puts it, albeit quite unfairly to the good teachers we all know, “Those who can, do; and those who can’t, teach”*).

According to David Rosenberg, Chief Economist at Toronto-based investment manager Gluskin Sheff, & prior to 2009 Chief North American Economist at Merrill Lynch in New York, 60% of US corporations’ per share earnings growth since 2009 has been a function of their share buyback programs (in 2013 total buybacks amounted to US$476BN vs. IPOs of just 55BN). According to Wiltshire at year end 2013 the market cap of all US stocks was US$21TR (124% of GDP), up from US$9.1BN (66% of GDP) at the end of 2008, & Warren Buffett, whose Berkshire Hathaway flagship is currently over 10% in cash, once observed that the TMC (Total Market Cap) over GDP ratio is “possibly the best single measure of where valuations stand at any given moment.”

David Hay is CIO of Bellevue, Wash.-based Evergreen Capital Management (that was acquired a couple of years ago by Hongkong-based GaveKal) who, in a recent think piece as to what the future might hold for United States expressed the hope that by then Congress would have started behaving more like “a representative of the people rather than an ATM dispensing tax payers’ money to the most politically connected.” - *a worthy, but wildly optimistic sentiment with a current probability akin to that of teaching pigs to fly.*

Louisa, Va.-based Investors Intelligence[2] has long maintained a Bull/Bear Ratio (the numerator of which is the number of professional money managers that is bullish on the US stock market & the denominator the number of their bearish counterparts). Historically readings over 3.0 have heralded market tops & readings below 1.0 market bottoms (thus in 2008 the reading was in the 0.5 range). The most recent reading, as of September 23rd, was 3.14; the good news of which is that it is well down from readings in the 4.20 range that occurred twice earlier this year, but the bad news that those readings had been the highest since 1987.

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1 Who according to the Daily Mail quit the PIMCO job earlier this year after being presented by his ten year-old daughter with a list of 22 milestones in her life, incl. her first day at school, that he had missed due to keeping a schedule of sleeping from 9:00 p.m. until 1:00a.m, writing until 4:30 a.m. & arriving at the office at 9:00 a.m. after having spent five hours on the trading floor.

2 Might this be an oxymoron?

According to <u>The Economist</u> in the US, its widening inequality & progressive tax code means 40% of households don't pay any personal income tax, while the top 1% accounts for 46% of all such tax collected (vs. 18% in 1979), & tax deductions/exemptions now amount to 7% of GDP

Caterpillar's global sales at last report had declined for 21 months straight (two months more than during the Great Recession) after their YoY growth rate had declined from 40+% to zero in the preceding 21 months.

One example of a potential problem in the international banking community is that of Banque Santander SA, Spain's biggest-, and Europe's 9th- , & the world's 11th-, largest bank. It generates a bountiful dividend yield, about 80% higher than the 4.9% average. But there is more to this than meets the eye. For since 2009 it has been giving shareholders the option of taking their dividends in shares rather than cash & they have responded overwhelmingly since doing so is tax-free. But this has had several consequences. It has hiked the number of shares outstanding by 31.6%. The cash portion of its dividend payout has dwindled from 88% of a total 5.0BN Euros in 2009 to just 12% of 6.6BN Euros in 2013. And last, but not least, it has enabled it to have dividend payout ratios of almost 100% in 2011, 300% in 2012 & 150% last year - *in light of the above, one wonders what possessed Euromoney to designate Banque Santander in 2012 as "The Best Bank in the World" for the third time in seven years. And one doesn't need to be the financial equivalent of a brain surgeon or a nuclear physicist to appreciate, especially given the still problematic Spanish economy & the continued separatist rumblings in Catalonia (Spain's richest & most industrialized region), that this bank is an accident looking for a place to happen, the timing of which may well have been moved up with the death of 79 year-old Emilio Botin, its Chairman for the past 28 years & the architect of this dividend policy. And, while the next day's appointment of his daughter Ana, age 53, to succeed him will provide continuity, & she may be well qualified for the job, having spent 8 years at JPMorgan & the last 25 at the bank, most recently as the head of its London operation, the fact remains that when she was up for re-election to the Board earlier this year, two shareholder advisory firms solicited votes were opposing iit (on the ground that the Board had already too many Botins on it).*

Gilles de Kerchove, the EU's anti-terrorism chief, told the BBC earlier this week that the number of Europeans who have gone to the Middle East to join Islamist fighters (*not necessarily solely ISIS*) is over 3,000, and that the Western airstrikes increase the risk of retaliatory attacks in Europe (*& North America?*), in part because groups that compete with ISIS for the public's attention may want to do so to keep themselves in the public eye - *such attacks seem almost inevitable, the only question being what the public's-, & the politicians'- , reaction will be to them; will they rear back in horror and try & crawl in their hole, hoping it will go away, or will they get mad first & then serious about fighting this existential threat - one fears they will choose the former but one hopes for the latter.*

ECB President Mario Draghi has been on sort of a European speaking tour. In that context he gave an interview to Lithuania's business daily <u>Verslo Zinios</u> in which he said among others :

- "the European economy has been recovering since the Second Quarter of 2013 ... (*although*) the recovery seems to have lost momentum recently;
- "we do not see Japanese-style deflation in the euro area ... because the ECB took decisive action at an early stage and has continued to do so";
- the response to those in Lithuania who say the economic benefits of in the euro area are offset by their rising cost is that "Joining the euro area is not a free lunch"; and
- while "it is true that the credit dynamics (*i.e. bank lending*) remain weak ... banks have been reporting an increase in loan demand ... for two successive quarters as well as an

easing of credit standards ... (*but*) but we should not forget that credit standards overall remain rather tight from a historical perspective ... (*so*) we decided ... to adopt a number of additional monetary policy measures, specifically designed to support the extension of credit to the real economy[3] ... (*to*) help inflation rates return to below, but close to, 2%."

The central bankers' blind faith in their ability to control inflation, once they have succeeded in fueling it, is admirable but not backed up by empirical evidence; so this is a case of "this time it's different" (which in the past has seldom, if ever, been proven correct).

China's housing sector directly accounts for 15% of China's economy[4] (& indirectly, but materially, affects dozens of other industries); so it is small wonder that Beijing has been pulling out all the stops to try & orchestrate a 'soft landing' for it. But this has not stopped Goldman Sachs (which long has had an greater than average involvement in the Chinese economy) from cutting its Third Quarter GDP growth forecast from a 7.3% annual rate to 7.1%, Fourth Quarter from 7.2% also to 7.1%, for 2014 as a whole from 7.7% to 7.3%, & for 2015 from 7.6% to 7.1%.

By September 23rd 17 cities in China's Guangdong Province had reported 6,069 cases of dengue fever; two days later that number had risen almost 25% to 7,497 (nearly 14x the number reported in the year-earlier period), with the hotspot being the Provincial capital Guangzhou that accounted for 6,000+ cases) - *this is a disease that doesn't get much notice, despite the fact that there may be as many as 100MM cases a year, because of its low (1%) fatality rate; nevertheless, its economic impact must be considerable.*

GLEANINGS II - 581
Thursday September 25th, 2014

THE BARBARIANS WITHIN OUR GATES (Politico, Hisham Melhem)

- With his decision to use force against the violent extremists of the Islamic state, President Obama did more than knowingly entering a quackmire ... (*he*) stepped once again - with understandably great reluctance - into the chaos of an entire civilization that is all but gone. For the Arab world today is more violent, unstable, fragmented & driven by extremists, on the part of **both** rulers & opposition, than at any time since the breakup of the Ottoman Empire nearly a century ago. With the dubious exception of the antiquated monarchies of the Gulf (which for the moment are holding out against a tide of chaos) & possibly Tunisia, there is no recognizable legitimacy left in the Arab world.

This is an inadequate summary of an article by the Washington Bureau Chief of the Dubai-based Al-Arabya news network, that you may wish to google & read for yourself.

U.S. DOLLAR IN LONGEST RALLY SINCE DAYS OF BEATLES (BB, Andrea Wong)

- The US Dollar Index the Intercontinental Exchange Inc. uses to track the greenback against the currencies of its major trading partners closed up 0.6% on the week to a post-June 30th, 2010 high. It has now risen for 10 consecutive weeks, the longest such stretch

[3] Last time around it didn't quite work out that way; the banks just took the easy way & 'made a spread' by buying government bonds.

[4] About triple that in the US.

since at least March 1967 & is up 5.9% YTD, the most since 2008. This prompted BoA/ML's Athanasios Vamvadis to comment "The Fed and the BOE are two central banks that'll start hiking rates next year, and we like being long dollar and sterling" and Stan Shamu, a Melbourne, Australia-based market strategist at IG Group Holdings Plc. "This hawkish twist to the Fed is pushing the greenback higher, and at the same time all its major peers are looking structurally weak ... The US dollar is probably going to continue in very good form." More specifically, of the various currencies the Canadian loonie was the biggest winner (up 1.2% - the biggest increase in two years- on news that inflation in the country had risen more than expected, & sterling was up 0.1% following the NO victory in the Scottish referendum, while the biggest losers were the Yen (down 1.6%), followed by the Aussie dollar (down 1.3%) & the Brazilian cruzeiro (1.2%), on polls that showed President Roussef increasing her lead over her challenger, Martina Silva.

This was largely driven by the September 16-17th FOMC meeting raising its median estimate of the Fed Fund rate by the end of 2015 from 1.125% to 1.375%, & the market expecting the Commerce Department to raise its Second Quarter GDP growth estimate from 4.0% to 4.6%.

<u>LOW INFLATION FUELS CAUTION AT FED OVER RATE RISES</u> (Reuters, Ann Saphir)

- Policy makers at the Fed this week began fleshing out their thinking on the path for US interest rates, with several of them calling for restraint & suggesting a willingness to push the economy past full employment to ensure a robust recovery & vanquish deflation, with New York Fed President Bill Dudley (*whose salary is paid for by Wall Street*) was the first to make the case for running the economy "hot" so as to revive flagging inflation.

According to research by the Cleveland Fed the recent strength of the US dollar is unlikely to have much of a downward effect on inflation (although low inflation elsewhere, especially in Europe & Japan, continues to be a drag on the rate in the US) while according to JPMorgan the strong dollar will create a drag on US GDP growth (to date by about 0.3%).

<u>MANY AMERICANS RENOUNCE CITIZENSHIP, HITTING NEW RECORD</u>
(Forbes, Robert W. Wood)

- One of Facebook's five co-founders, Brazil-born Harvard graduate Eduardo Saverin, decamping with his IPO riches to Singapore created such an angry backlash that Sens. Charles Schumer (D.-NY) & Bob Casey (D.- Penn.) introduced a bill to double the exit tax on anyone leaving the US for tax reasons to 30%.
- The US Treasury is required by law to produce a list each quarter of people it knows to have renounced their US citizenship or terminated their long-term (*green card?*) US residency status (a number which many believe vastly understates the number of those who have actually done so). Be that as it may, by the Treasury's count the number that did so in 2013 (2,999) had been up 221% YoY (although it seems to have slowed down this year to a 500+ quarterly rate).

As not uncommon, the headline is an exaggeration.

<u>OIL PRICES WOULD HIT $150 PER BARREL WITHOUT U.S. SHALE</u>
(Reuters, E. Scheyder)

- In an interview on September 24th Adam Sieminsky, the head of the EIA (the US Energy Information Administration), said "If we did not have the growth in North Dakota, the

Eagle Ford and the Permian oil could be $150 (per barrel) ... There is a long list of countries with petroleum outages that add up to about 3 millions barrels a day." And while some skeptics wonder if North Dakota's oil boom will peter out like those in the 1950's & 1980's, Sieminski expects its oil output to ramp up from last July's 1.1MM bbld to 2.0MM bbld (*elsewhere the EIA reported that the amount of oil riding on US rails any given day now is 1.6MM bbld & that railroad oil shipment revenues had risen 833% in five years*).

The bottom line of all this is that, absent a "black swan event", there may be sustained downward pressure on oil prices for some time to come. There is a phenomenon called the 'cattle cycle' whereby, when cattle prices decline, farmers seek to maintain their income by selling more cattle, taking them from their breeding herd & thereby in the short run adding to supply & accentuating downward price pressures (& longer term adding to upward price pressures because they have fewer cattle to sell two, three years down the road). Something similar occurs in the crude oil market; for the governments of many major oil producing countries (incl. Russia, Saudi Arabia, Iraq & Iran, Mexico & Venezuela, & Libya) depend heavily on oil revenues to fund their budgets. So when the price of oil declines sharply, as it has in recent months, they tend to exert pressure on their oil companies to boost output[5] so as to keep the money coming, thereby reinforcing any already existing downward price pressures, and/or to syphon off more of their cash flow (which longer term affects their future productive capability by forcing them to skimp on the maintenance of their existing infrastructure & on investing in reserve replacement). So those who see the price of oil going further down still may well be proven right, especially so given the benefits for Washington from lower oil prices (incl. a higher rate of GDP growth at home & abroad, an improved balance of payments &, possibly most importantly in geopolitical terms, complicating life domestically for Mr. Putin by depriving him of much-needed budgetary revenue-, & GDP-, growth. This is also true in spades for the concomitant growth of US shale gas output : it has now surpassed Russia as the world's largest natural gas producer, some of which will leak into global LNG markets, with consequences for Russia's natural gas hegemony in Europe long before it can start selling its gas to China (on far less favorable terms than in Europe).

<u>STATOIL CALLS OFF 40,000 BPD CANADIAN OILSANDS DEVELOPMENT</u> (Reuters)

- It announced on September 25th it will postpone development of its 40,000 bbld Corner project in Alberta for at least three years due to inflation pushing up the cost of labour & materials, 'tightness in pipeline space' to the US market, & the lower price it is getting for oil (while the current US$13 discount from WTI for Western Canadian Crude is at a 14 months' low, the current WTI price has taken it to break-even for some Alberta producers.

This will not affect its 20,000 bbld. Leismer demonstration facility that came on stream last January as the first of a cluster of a four project Statoil presence in the Alberta oilsands that so far has cost it US$3.7BN (US$2.2BN to buy its way in & US$1.5BN more in development costs since). Back last December already Statoil's CEO warned reporters in Calgary that its oilsands projects would have to compete for funding with projects elsewhere (& Corner likely lost out to offshore Newfoundland where Statoil, in partnership with Canada's Husky Energy, last year made a discovery in the Flemish Pass Basin off Northwestern Newfoundland that was its biggest offshore discovery ever outside the North Sea, that supposedly was the 12th largest find anywhere in the world in the previous four years, & which has the dual advantage for Statoil that

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5 *it is worthy of note in this context that Saudi Arabia's output currently is at an all-time high,*

it involves technology with which it has long since become wholly familiar & that the oil produced will have absolutely no market access constraints.

<u>PETRONAS MAY PULL OUT OF B.C. LNG PROJECT</u> (CBC)

- On September 24th, ahead of a visit to Canada, Shamsul Abbas, CEO of Malaysia's national oil company Petronas, said it may pull out of its $10BN LNG project in British Columbia due to Canada's slow progress on a new taxation scheme, saying "Canada has to buck up real fast to be a credible LNG player ... Rather than ensuring the development of the LNG industry through appropriate incentives and assurance of legal and fiscal stability, the Canadian landscape of LNG development is ... one of uncertainty, delay and short vision."

*This is clearly intended as a shot across the bow, less so for Ottawa than for the BC government, that is still trying to figure out how to maximize, rather than optimize, its take from the LNG business; be that as it may attitudes like this, & of the one immediately above, constitute serious threats to Prime Minister Harper's plan to turn Canada into a "petro-nation" (& who, that very same day, told a New York audience "logic dictated ... that the US will one day approve" the Northern, cross-border leg of the controversial Keystone pipeline; for, he said, while the increase in US oil production has changed the economics of the industry, the need for the pipeline has not changed since "American self-sufficiency is a long way off". But given his refusal for a time line to support his thesis, while he may well be right in general terms, this is not necessarily good news for Alberta (& for the nation) since, for the planned growth in Alberta oilsands output that everybody is counting to materialize, pipe should be in the process of being put into the ground **right** now!*

<u>CHINA'S STEEL CONSUMPTION DROPS</u> (Reuters)

- In the first eight months of the year it declined for the first time since 2000, by 0.3% YoY to 500MM tonnes & in July was down 1.9% YoY to 61.9MM tonnes. Meanwhile the supply of iron ore grew 81MM tonnes, causing a price drop to < US$80 for the first time in four years. And steel output is expected to grow by 6% YoY while Brazil's Vale, the world's No. 1 iron ore producer, plans to hike its iron ore output to 453MM tons by 2018, up 48% from 2013 on the grounds that "the cycle of development and urbanization in China will continue for another ten years."

Meanwhile, nine year-low prices for steel products are raising havoc in China's steel industry with mills closing everywhere. Rumours abound that Sinosteel, the country's biggest steel trader, is in trouble. Although it has acknowledged it is 'facing difficulties' due to its customers not paying their bills on time, a company official denied a restructuring is in the cards. Nevertheless, it is widely believed unable to pay its bills, to have overdue loans of 10BN Yuan (US$1.63BN) & to have defaulted on a loan to ICBC, and that Beijing is readying a 20BN Yuan (US$3.25BN) bailout. None of this would entirely surprising since in three years ended last December 31st its 'main business income' shrank 25% to 140BN Yuan (US$22.5BN).

<u>BIG MINERS STRUGGLE TO TAME CHINA WITH IRON ORE GLUT</u>
(Reuters, David Stanway)

- The world's biggest miners' plan to knock out smaller, higher cost rivals with a glut of cheap iron ore is meeting resistance where it was to have counted most, in China. While it has been successful in shutting down a number of small, high-cost operators there, the big state-backed producers are expanding & consolidating. Rio Tinto, *the world's No. 2 iron ore producer*, earlier this month said it expected to see 125MM tonnes of iron ore capacity shut down this year & that so far 85MM tonnes had already been cut, notably in China, Iran, South Africa & Australia. Nevertheless, China's National Bureau of Statistics reported that YTD domestic iron ore output had risen by 8.5% to a record 986MM tonnes.

There are at least three possible explanations. Imported ore has a much higher iron content (60%) than the locally-mined product (the average iron content of which had declined by one-third to 21% in the past decade). Many of the local mines are owned by-, integrated with-, & located conveniently close to-, local steel mills. And Beijing is growing concerned that the loss of jobs associated with a slowing economy will lead to widespread social unrest.

MOSCOW'S 'MR YUAN' BUILDS CHINA LINK AS PUTIN TILTS EAST
(BB, Evgenia Pismennaya)

- In 2010 Igor Marich introduced the buying & selling of Yuan in Moscow. Now, with Western sanctions over Ukraine having prompted more Russian companies to look East, his business on the Moscow Exchange has jumped ten-fold (to US$749MM per month). While still puny compared to the US$367BN dollar-for-ruble sales (although it hit a peak of 666MM Yuan/US$109MM on July 31st), Marich expects his *average* daily turnover to hit 1BNYuan/US$165MM within the year (with others expecting it to happen sooner).

If Putin truly believes that the Russian Bear can be a match for the Chinese Dragon, he may be in for a most unpleasant surprise.

IRELAND'S GDP SURGES AHEAD OF EUROZONE (WSJ, Paul Hannon)

- Its economy continues to recover from its 2008 property market & banking collapse. This week its Central Statistics Office (CSO) reported that in the Second Quarter GDP had been up 1.5% QoQ & 7.7% YoY (while for the Eurozone as a whole it had been flat). Whereas economic growth in recent years had disappointed the government & international lenders (even though the former late last year had been able to pay back all its emergency funding from the IMF & the EU) because of weak growth in the UK & the Euro zone, the return to rapid growth in the UK (& some pickup in Eurozone growth) contributed to its now strong recovery; for according to the CSO in the Second Quarter exports & 9.1% growth in business spending[6] more than offset relatively weak (0.3%) growth in consumer spending (that is still being held back by the legacy of large mortgage debts, high unemployment & higher taxes).

Ireland is the living embodiment of the old stock market adage that 'the first loss is the easiest to take'. After its Eurozone 'partners' in 2008 sucked its then government into bailing out its banks, rather than having them go under & have their own banks pay the price for their stupidity, instead of resorting to fancy footwork by its central bank[7], it went back to basics &, among others, cut government spending back to the level it had been half a dozen years earlier; and in contrast to much of the rest of the Eurozone, the Irish people supported it doing so, albeit not happily so. Having said that, it paid a price in terms of increased emigration & massive

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6 In part a function of Beijing having chosen Ireland as one of its key entry points into the EU.

7 The balance sheet of its central bank is now 55% **lower** than its August 2009 post-crisis peak.

unemployment (incl. a rate of youth unemployment that peaked a couple of years ago at 30%, although it has since been able to whittle that down to 25%, whereas in the other PIIGS countries the youth unemployment rate peaked at much higher levels (57% in Greece & close to that in Spain) and where, with the exception of Portugal, it is now ***higher*** *than two years ago). And its Debt-to-GDP ratio at least report stood at 116%, well off its peak last year of 124% & the government appears within sight of conforming with the EU requirement that government deficits should not exceed 3% of GDP*[8]

8 *it is worthy of note in this context that Saudi Arabia's output currently is at an all-time high,*