

**Quote of the week :** “Markets are perpetuating a serious error by acting on the belief that central bankers actually know what they are doing. They do not. Not because they are ill-intentioned but because they are human and subject to the same limitations that apply to all human endeavours. Despite their efforts to do so, central banks cannot repeal the business cycle (though they can distort it). While the 2008 crisis should have taught them that lesson, it appears to have led them to precisely the opposite conclusion.” - Michael Levitt, The Credit Strategist, November 1<sup>st</sup>, 2014 (he co-founded Boca Raton, Florida-based Harch Capital Management in 1991 where managed portfolios of below-investment grade debt & two years ago founded the Credit Strategy Group there to do more of the same. He has been writing this publication since 2001 & was credited by the Financial Times as one of few people to have forecast both the 2001-2002 & 2008 financial crises.

As to the outcome of the US elections, the view “The hard right is not in control of the agenda any more. The inmates are no longer running the asylum” may prove correct only where the first observation is concerned. For the agenda will now be controlled by inmates on both sides with a singular focus on the 2016 Presidential Election. But two things now seem sure. One is that the Democrats should run Hilary Clinton or Joe Biden only if they have a death wish (or for lack of a better option since they may not be able to groom a credible candidate that would give them a fighting chance in 2016 in the 18 months available to do so). And the second that future historians are likely to classify the Obama Presidency as a “missed opportunities” era just as they may classify the Bush 43 Presidency as a “woolly-headed priorities” one.

On October 1<sup>st</sup> Saudi Arabia cut the price of its oil for Asian buyers in a market share protection move to meet competition from Latin American producers pushed out of the US market by shale oil. And this week it cut its prices to North American customers as well. While many Americans see this as an effort to cut US shale oil output<sup>1</sup>, this is not correct. For its real targets are, in order of importance, Iran (for the Saudi Royal family feels threatened by its attempts at regional dominance & at acquiring a nuclear capability, and by the Shia regime it supports in neighbouring Iraq), Russia (for being in cahoots with Iran & actively propping up the al-Assad regime in Syria), its fellow OPEC members who won't cut output when there is an oversupply of oil (*but who may have little choice but to maintain, if not hike, output when the price is 'soft' given their undue dependence on oil revenues to make ends meet*) and then, & only then, the US shale oil producers (whose price pain threshold they know is far lower than that of many of the aforementioned<sup>2</sup>). Meanwhile OPEC, that will hold one of its periodic meetings on November 27<sup>th</sup>, is sending mixed signals : while its officials say they would “panic” if Brent were to go to US\$70 (*from its current US\$83.65*), OPEC's Secretary-General, Libya's Abdalla Salem el-Badri, went on record as saying “the media is panicking, the market is panicking, the consumer is panicking (???) and the producers are panicking. We really should sit and relax.” (meanwhile the oversupply situation will likely be aggravated by Libya's announcement that it

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<sup>1</sup> In this context it is interesting to note that since early September, when KNOC (Korea National Oil Company)-owned Harvest Operations Corporation sold its money-losing Come-by-Chance 115,000 bbl/d oil refinery in Newfoundland to a little-known New York real estate firm, SilverRange Financial Partners, the new owners have switched from Middle East (Iraq) -, to US shale oil-, feedstock (where it may have a competitive edge over its US competitors because being a Canadian destination the Jones Act (that stipulates that all freight hauled by sea from one US port to another must do so on US-built, US-owned, & US-crewed vessels.

<sup>2</sup> And while US shale oil producers are proclaiming their ability to deal with significantly lower prices, their capex programs will tell the real story; for, given the relatively short productive life of shale oil wells, to maintain and/or increase shale oil output an ongoing drilling program is a sine qua non.

will soon restart its 300,000 bbl/d Sharara oil field (that had been shut down following an attack by militants) and by the increase in oil exports from Iraq's Kurdistan by 300,000 bbl/d (that it expects to ramp up early next year to 500,000 bbl/d).

Credibility is a precious asset that takes much effort, time & money to build, but can be lost in the blink of an eye. And in a fractional banking system it is a sine qua non for financial institutions; so it was interesting to see Jim Grant recently noting that during the Fed's Bernanke era :

- as QE1 came to a close, the market was told there would be no more QE;
- as QE2 came to a close, the market was told there would be no more QE;
- as QE3 came to a close, the market was told there would be no more QE;
- Operation Twist was to have ended on September 30<sup>th</sup>, 2010, but wasn't;
- calendar guidance (*giving a 'no change' time frame*) was offered but abandoned;
- forward guidance was offered & then largely abandoned; and
- economic guide posts (the 6½% unemployment-, and 2% inflation-, came & went.

So he concluded that in each case the market had been right in ignoring what the Fed said & had priced in a more accommodative policy - *this came after Greenspan had anointed 'financial engineering' as a positive, risk re-allocation methodology, only to be made to eat his words, causing market players to have growing doubts about the allmighty Fed' & its Teflon reputation. Historically one important item in central banks' tool boxes was "moral suasion", the quiet, behind-the-scenes, & often very personal, coaxing & cajoling of and, if necessary exertion of pressure on, commercial bank executives to behave in the way the central banks wanted them to. And the less effective that tool becomes, the less will central banks be able to influence the course of events.*

In July Canada's rate of GDP growth disappointed many when it was zero MoM, only to have August be worse still when, contrary to expectations, it was a negative 0.1% MoM, due to weakness in the oil & gas<sup>3</sup>-, & the auto-, sectors, both of which had fueled the First Half's growth. And while in August GDP was still up 2.2% YoY, this was well down from the Second Quarter's 3.3%. The National Bank of Canada's Senior Economist, Krishen Rangasamy, said in a note to clients "Given the poor start to the quarter, it will now take growth of more than 0.5% in September to hit the Bank of Canada's *forecast* Q3 GDP growth of 2.3 per cent annualized ... For now, the monthly readings are indicating Q3 growth just under 2% annualized ,i.e. about half that of the U.S. economy in the quarter" - *while most economists believe that given the strong US economy, the summer's lull will prove fleeting as it pulls in more goods-, & energy- (???)*, imports from Canada<sup>4</sup>, skeptics fear their optimism will prove unfounded.

The Deutsche Bank, Germany's largest-, & the world's 3<sup>rd</sup> largest-, bank<sup>5</sup> has informed its customers that, effective November 1<sup>st</sup>, retail deposits > 500,000 Euros, will be subject to a 0.25% annual levy, something which is variously referred to "a confiscation of capital in plain sight", "punishment interest" or the "wrath of Draghi" (the latter because when the ECB started charging banks for money they kept on deposit with it, it 'explained' that if the banks were to do likewise they should their customers this "would benefit savers ... because they (*negative interest rates*) support growth and thus create a climate in which interest rates can gradually return to higher levels".

As of 1133 hrs on November 4th) the US\$/Yen exchange rate was 113. 97, up from 76.60 in October 2011 largely as a result of policy decisions by Japan's Shinzo Abe government to debase the country's currency. This has major collateral damage (competitive) implications for its Asian neighbours & one wonders if history, once again, may repeat itself; for a not dissimilar change over a not dissimilar time period two decades ago, when the US\$/Yen rate went from

<sup>3</sup> August's 2½% slump in oil & gas extraction came on the heels of a 1.6% decline thereof in July.

<sup>4</sup> With fracked oil & gas 'coming out of its ears'?

<sup>5</sup> After ICBC (US\$2.95TR) & HSBC (US\$2.68TR), & ahead of Crédit Agricole (US\$2.5TR), BNP (US\$2.51TR), Mitsubishi Financial (US\$2.49TR), Barclays (US\$2.41TR) & JPM (US\$2.39TR), although these rankings likely have changed due to the strong US dollar.

83.83 in April 1995 to 125.56 in April 1997, was followed in short order by the 1997 Asian Currency Crisis.

Japan is getting closer to the day it will graduate from just being an accident looking for a place to happen to a full-fledged train wreck. Its debt-to-GDP ratio is closing in on 250%. This year's government deficit, at 7.6% of GDP, may be down from 9.2% YoY but is triple that in 2008. For years its tax revenues have covered 60%, or less, of its expenditures & the year ended March 31<sup>st</sup>, 2014 was no exception : while the budget had called for taxes to cover 44% of its expenditures & the outturn was 49%, due to 1½ % lower-than-expected spending & 9% higher-than-expected tax revenues (due to higher capital gains tax revenues from the booming stock market & higher corporate earnings since the lower yen made its export industries more competitive & their foreign currency earnings more valuable in yen terms), this is not sustainable. And now its pension funds & insurance companies are bailing in wholesale fashion out of JGBs that yield 0.11% & 0.45% for five-, & ten-, years respectively, supposedly out of doubt about the government's future ability to meet its debt service obligations in a timely & orderly fashion<sup>6</sup>. And now to top it all off, the Bank of Japan is scheduled for the foreseeable future to buy twice the amount of new debt the government is issuing (the overage to absorb the persistent institutional selling); this means that its balance sheet (that already has nearly doubled to close to 300TR yen since January 1<sup>st</sup>, 2012, after having ranged between 100TR & 150TR yen during the preceding six years) will grow at a 1.4% monthly rate (i.e. an 18.2% annual rate, which, if it were to go on for four years would double its balance sheet once again, to a size in relative terms far greater than those of the Fed, the ECB & the Bank of England.

For the last decade or so, Georgia has flirted with the idea of closer links with the EU & has been touted as a way to get Caspian Sea oil & gas to world markets without having to cross Russian soil (something many people believe was partly/largely/totally responsible for its attack on Georgia in 2008). But this week's sudden resignation of several pro-Western ministers & senior officials, is making observers worry that, while all are focused on Putin's moves in Ukraine, he has quietly made Georgian Prime Minister Irakli Garibashvili, like former Ukrainian President Yanukovich earlier this year, an offer he couldn't refuse to ditch the idea of closer links with the EU in favour of letting his country be drawn back into the Russian orbit (which both, of course, strenuously deny)

While in the 1920's Mustafa Kemal Ataturk sought to transform Turkey into a modern, secular state, by 2002 the Turks were split evenly on the role Islam should play in their country's politics. Then, when the now Turkish President Recep Tayyip Erdogan became Prime Minister, he launched in 2002 a campaign to de-emphasize secularism & promote the role of Islam, for instance by clamping down on alcohol sales & modifying a law that wouldn't let government workers to wear hijabs (*his wife always wore one in public*). And he seems to have succeeded; for a recent Pew Research Center poll found that now 69% of Turks say that Islam is the dominant force in politics - *this could have major geopolitical implications by making Turkey an easier target for ISIS*.

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In which endeavour it was recently joined by the world's largest pension fund, the government's US\$1.3TR GPIF (Government Pension Investment Fund), ostensibly for diversification reasons - it was traditionally huge overweighted on the fixed income side).

## **WHY U.S. MONETARY POLICY FAILED (FP, Herbert Grubel)**

- According to neo-Keynesians like Paul Krugman & Larry Summers the extraordinary easing of monetary policy of recent years failed to produce the results expected on the basis of past experience *simply* because it was not accompanied by sufficient fiscal stimulus in the form of more deficit spending. But for a couple of years the deficits were the highest in US peacetime history by far; in addition, there is now much empirical evidence that only half of past fiscal stimulus programs in the world have been successful.
- One reason for the failure of monetary stimulus to have the expected effect was that the deficits created uncertainty about the future taxes needed to service the resultant debt & concerns about the possible use of inflation to cut the real cost of doing so. Another was that in the past massive increases in the high-powered money base such as the Fed used to maintain the zero interest rates have typically led to high inflation; this too reduced confidence in the future. And a third reason lay in President Obama's anti-business rhetoric which demonized financial success & threatened it with higher taxes. But by far the most important reason why monetary stimulus didn't restore consumption, investment & *general* prosperity was the growth in, & *the complexity of*<sup>7</sup>, regulations, be they to protect consumers, implement Obamacare, increase the stability of banks or protect the environment & deal with climate change<sup>8</sup>. For this added to the cost of doing business & lowered the returns to investment & innovation. The regulatory approval process needs to be overhauled to give more weight to unintended & diffuse costs & existing regulations reviewed periodically & eliminated if costs exceed benefits (*a process which, if history were any guidance, would likely be far too short-term focused.*

*The writer is a retired economics professor at Vancouver's Simon Fraser University & a Senior Fellow at the (right wing) Fraser Institute. While it may therefore be easy to dismiss this as right wing orthodoxy, there likely is more than a little truth in it. But the biggest problem will be to find a reasonable balance between the blinkered rightwing dismissal of the need for any regulation & the equally blinkered left wing tendency to over-regulate.*

## **U.S. MIDTERM RESULTS COULD SPELL TROUBLE FOR THE WORLD** **(Nikkei Asia Review, Hiroyuki, Kotake)**

- The threat of war & terrorism is not waning & the world cannot risk a retreat from it by the global powerhouse. Beijing is wary of the election results since Republicans tend to be tougher on their country. The fate of the TPP (Trans-Pacific Partnership) trade pact<sup>9</sup>

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<sup>7</sup> Thus while the Glass Steagall Act of 1933 (that separated commercial from investment banking was just 47 pages long, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ran to over 8,000 pages.

<sup>8</sup> Thus the growth in the number of pages of regulation in the Federal Register has been running at an 80,000+ annual rate

<sup>9</sup> There are currently two competing Asia-Pacific free trade proposals on the table. The one pushed by Beijing, with the moniker FTAAP (Free Trade Area of the Asia Pacific) would include all APEC members, while the TPP (Trans-Pacific Partnership) would be limited to 12 nations, not including China, that, almost a decade after it was signed, still is still born (although that may now change since the Republicans are generally pro-free trade and might be motivated to push it by the exclusion of China (which the latter would view as yet another aspect of US 'encirclement').

will be a key issue. And Obama's mantra of bipartisanship alone won't move *US* politics forward; the two parties must join hands for the sake of the US & the world, and unless the country comes together the world will face serious turmoil over the next two years.

*Obama said the day after the elections he wants immigration reform by year end, if necessary by Executive Order, while Mitch McConnell, about to become Senate Majority Leader, has indicated that if he did so this would seriously undermine the prospects for bipartisanship.*

### **IN THE SUNSHINE STATE, DARK CLOUDS OF CYNICISM (G&M, Margaret Wente)**

- Florida will soon be the third-most populous US state, replacing New York. And Miami is representative of a nation in which the wealthy are increasingly isolated from the middle class & the poor<sup>10</sup>, and in which massive political apathy prevails. For people have given up on both parties, no longer believing their elected representatives are interested in helping them (or knowing what to do if they were). And many of them are poor, & getting poorer<sup>11</sup>, & many of the wealthy aren't American, but Russian, Brazilian, Venezuelan, or Argentinian, all of them happy to come & bring their money to live where government is stable, the currency hard, the climate great & the living easy. And yet there doesn't seem to be much resentment towards the rich since many people still believe in free enterprise & have an (*underground economy?*) sideline to make ends meet (*while paying little by way of taxes & yet requiring services from government for their families?*).

*One can only wonder how many of the imported wealthy are illegals here on a 'wink-wink, nod-nod' basis who are outside the US income tax system.*

### **DREAMS OF A SHORT WAR ARE EXACTLY THAT (G&M, Jeffrey Simpson)**

- Canada has committed itself to six months of combat against ISIS<sup>12</sup>. But anyone who believes it can be pushed back or "defeated" in that time frame is delusionary. According to the NYT last week the US military, in an off-the-record briefing in Baghdad, said it will be a "multi-year" campaign, with no ground campaign against ISIS in Syria feasible in the next 12-18 months. And Anthony Cordesman of the Washington-based Center for Strategic & International Studies says US military officials have told him "the struggle against violent religious extremism would go on for years, if not more than a decade."
- In a report for the RAND Corp. Seth Jones details how the number of "Salafist-jihad" groups grew 58% between 2010 & 2013 & flourished in countries, like Iraq & Libya, where previous strong leadership was shattered by internal dissent or Western intervention. While once al-Qaeda was the only Islamist 'game in town', there now are four, Pakistan-based al-Qaeda, factions in several countries affiliated with it *but 'doing their own thing'* (with some focused on the "near" enemy, the local government, & others

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<sup>10</sup> Ditto for Atlantic City, New Jersey, long the East Coast's gambling Mecca, whose population is down 40% of its peak in the 1930's (as the US population grew by 150%) and where the median household income in 2012 was US\$29,886 (down 8% in real terms from 1989).

<sup>11</sup> Thus in Orlando, "in the shadow of Cinderella's castle" (*at Disney World*) almost 40% of the jobs pay < US\$25,000/year and the Second Harvest Food Bank of Central Florida may well be the largest & most technologically advanced facility of its kind in the entire world.

<sup>12</sup> Which reminds one of the cheerily optimistic shouts of "We'll be home by Christmas" with which, according to historians, British troops marched off to war in the late summer of 1914.

on the “far” one, Western interests) *free-standing*, Salafi-jihadi groups & individuals inspired by jihadist thinking. ISIS is focused on the “near enemy”, the Syria & Iraq governments to realize its dream of a Caliphate, while al-Qaeda remains focused on the “far” one, to lure, as its leader, Ayman al-Zawahiri, put it, the US into over-commitments that would “exhaust & bleed her”.

- While Canadians may think the bombing campaign will do some good, last week’s Baghdad briefing noted that targets other than stationary ones, like oil refineries or headquarters, are hard to find now that ISIS has blended its fighters in with the population; so the USAF now flies just ten sorties a day in Syria, & five in Iraq, while it used to do fifty or more in Libya. And air power alone is of marginal use unless accompanied by the still rare ‘boots on the ground’. Meanwhile Bashar al-Assad must be thankful to the US for bombing ISIS targets in his country, so he can concentrate on fighting his other, non-ISIS opponents.

*According to the latest figures, foreign fighters are now responding to an increasingly sophisticated PR campaign, by flocking to Iraq & Syria at a 1,000 monthly rate, & experts warn these latecomers are more extreme than the earlier recruits; for many of the latter were driven by humanitarian considerations & thought of it as a finite commitment, while the former are truly radicalized & don’t expect to come back - but this very fact, & the evidence of ISIS massacres of Sunni Muslims who don’t see things their way, may in time prove its undoing; for both the Syrian & Iraqi cultures are steeped in a blood feud tradition, in loyalty to family, clan & tribe overriding all else, & in strangers always being suspect &, at the best of times, barely tolerated.*

#### **CRÉDIT AGRICOLE SLAMS GOVERNMENT POLICY AS WEAK FRANCE DRAGS ON BANK RESULTS (Reuters, Leigh Thomas)**

- In a November 6<sup>th</sup> conference call with reporters, after posting 4% higher quarterly earnings (with asset management & insurance results more than offsetting weak domestic retail results) Crédit Agricole’s CEO, Jean-Paul Chifflet, tore into the Hollande government, saying “signs of recovery are illusive, unemployment is high, the real estate market is in correction, the public deficit continues to overshoot amidst ‘insufficient spending cuts’ ... (and) the absence of a clear vision and lack of coherence in economic policy is weighing on confidence and, therefore, investment and economic activity.”

*This came at a singularly bad time for President François Hollande who, with a 12% approval rating, down from 15% MoM, was about to defend his record in a mid-term, prime time TV appearance in which he would face a panel of radio & TV journalists, as well as four voters.*

#### **IS RUSSIA NEARING AN ECONOMIC CRISIS? (Al-Jazeera, Mikhail Khodorkovsky)**

- Putin’s aggression outside Russia has created a situation in which national chauvinism is on the rise<sup>13</sup>. Seeing his popularity falling at home & the rise of national chauvinism, Putin has sought to take over the agenda by becoming extraordinarily aggressive. In so doing he has stepped on a path of no return that will destroy his regime, and create losses for Russia & the whole world that are as yet hard to fathom.

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<sup>13</sup> The way the Russian people have been made to perceive the global situation is that the West is punishing their country for having the audacity of pursuing an independent foreign policy.

*The writer has an axe to grind. For, once an oligarch, he was stripped of both his (Lukoil) oil company & his freedom when he started meddling in politics in ways that displeased Putin. So he spent ten years in jail before being pardoned in the lead up to the Sochi Olympic Winter Games. He now lives in Switzerland where he spends his time trying to mobilize reform-minded Russians through an entity entitled Open Russia. Be that as it may, it's worth noting his views.*

#### **KYIV TO SEND MORE TROOPS TO EAST UKRAINE (AP, Peter Leonard)**

- Over the October 31<sup>st</sup> weekend Ukrainian security officials claimed that, *after the 'elections there on Sunday that nobody but Russia recognizes as legitimate*, Russia had stepped up its transfer of troops & military equipment to the separatist rebels in the Eastern part of the country (a charge that Moscow *of course* denies) And in Washington Jen Psaki, a US State department spokeswoman told reporters that "in recent days, Russia-supported separatists have publicly stated their intention to expand the territory under their control." So President Petro Poroshenko said on November 4<sup>th</sup> that more troops were being deployed in the East, where fighting continues between government forces & pro-Russian separatist fighters, to defend cities still under government control against possible incursions.

*Chancellor Angela Merkel showed her displeasure with Russia's role in the conflict when she said there was no reason yet to lift the EU sanctions against Moscow.*