

Quote of the week : “All truth passes through three stages. First it is ridiculed. Secondly it is violently opposed. Third, it is accepted as self-evident.” - Arthur Schopenhauer (1788-1860), whose core belief was that the world isn't a rational place - *one wonders if this will apply to the gold bulls' case; for it seems to have left phase one behind & the central bank complex's switch a few years back from a net seller to net buyer, the declining volume of 'paper gold' outstanding & the move of physical gold from West to East could herald a move into the final phase.*

The controversial Rogoff/Reinhart study, after studying financial crises throughout history, concluded that once a country's Debt/GDP ratio goes through 90%, it appears to become a drag on its GDP growth potential. According to the IMF Japan's was 234% in 2012 (& has grown since), followed by Greece (159%), Italy (127%), Portugal (123%), Ireland (117%), US (107%), Belgium (99%), UK & France (tied with 90% each), Canada (86%), Spain (84%) & Germany (82%). But that's only part of the story. For of the Abe government's 96TR Yen (US\$921BN) budget for this fiscal year (ending next March 31st) only 57% was to be funded from tax revenues & the other 43% from net new borrowing¹. And all of the latter is now being taken down by the central bank (*by printing money*), **as well as** growing amounts of already outstanding JGBs that are being dumped as fast as they can by Japanese institutional investors. And of its planned spending, 32% was earmarked for mandatory social security payments to its aging population & another 24% for debt service charges (both up 5% YoY, while GDP was projected to grow by just 1.4%²). And here's the real rub : any increase in interest rates would eat up an even more unsustainable share of the government's budget. So to keep interest rates from rising, the BoJ must keep on monetizing the debt. But as long as it does so, the yen must keep on falling (to the point where some serious people are now talking of it going to 200 to the dollar³). But if it were to depreciate too fast, the BoJ would have to slow down-, suspend-, or altogether quit-, monetizing the debt. And if it did any of these, interest rates could not help but start rising, in which case the Abe government would be in even more trouble than it already is. Meanwhile, the rapid fall in the yen's exchange rate is increasing the risk of a currency war being forced onto the other countries whose goods compete with Japanese-made ones in world markets. Japan is a train wreck in the making, the only question being when it will 'hit the wall'.

On December 10th OPEC, which last month produced 30MM bbl/d, announced it expects 2015 demand for its oil to be just 28.9MM bbl/d, an 11-year low, & blamed the 1.36MM bbl/d increase (to 57.3 MM bbl/d) in non-OPEC output, (attributing most of the increase to the US, Canada & Brazil). This, the news that US crude inventories had been up 1.5MM bbls, whereas a 2.2MM bbl decline had been expected, the warning by an Iranian Oil Ministry official at a conference in Dubai that the oil price could go as low as US\$40 & the Saudi Oil Minister, while attending UN climate talks in Lima, Peru, saying response to a question “why should I cut production?”, combined to cause both Brent & WTI to decline by 4+% each to US\$63.84 & US\$60.08 respectively⁴. Moreover, the EIA in its December Energy Outlook cut its 2015 WTI price forecast

¹ A proportion that is likely to be increased by the Abe decision to defer the second instalment of the sales tax increase & by the Japanese economy appearing to have gone into recession.

² A number that now looks highly improbable after GDP 'growth' of a negative 7.1% in its first-, & , more recently, a negative 1.9% in its second-, fiscal year quarters.

³ Vs. 76 in January 2012, 97 on October 2013, 107 two months ago & 119 at last report.

⁴ One increasingly likely looming risk to the system is that ETFs & others who are heavily invested in junk bonds will deem it necessary in the New Year to start cutting their payouts to investors.

for the second month in a row from US\$77.75 last month to US\$62.75⁵ (&, incidentally, noted that the average US gasoline price this month, at US\$2.49, is down 32.5% MoM). And one (credible) market observer believes that Saudi Arabia won't cut output until Iran makes a deal with teeth with the US-, **and** until Russia cuts production-, first (with the probability of the former low-, & of the latter even lower, at least over the short-to-medium term, or until the amount of pain inflicted on their hoi polloi forces regime changes⁶).

I have long been a believer in the value, as canaries in a coal mine, of anecdotal economic evidence from the grass roots, from taxi drivers & bar owners whose cash flow is discretionary spending-driven, and to a lesser extent from retailers & others at the "sharp end". In recent months I have come across four info bytes that suggest Alberta may be in for heavier weather than the CW holds. Three months ago a truck driver who had been making a bundle hauling to Fort McMurray told me "in the past ten weeks my business has fallen off a cliff". A little while later, a bar owner I know commented in similar, albeit less vehement, vein. Then on December 3rd a teacher friend whose school has a fund-raising dinner cum silent auction each year around this time told me his principal was worried since only 69 \$20 tickets had been sold vs. 170 last year; sure enough the crowd last Friday was thinner-, the supply of donated goods from fewer donors of lesser substance-, & bidding less spirited-, than last year. And then to top it all off, on December 10th on a transit bus, I overheard a frail-looking septuagenarian lady telling a middle-aged immigrant from Eritrean origin that Alberta was in for hard times since the oil price was going to "stay down for at least two years."- she may not be an expert on the issue, but sentiments like this will-, & already seem to be starting to-, effect consumer spending.

Bank of Canada Governor Stephen Poloz⁷ on December 11th warned that the Canadian housing market is 10-30% overvalued. Nevertheless he maintains it is still headed for a 'soft landing' since "We believe the economy is gathering strength; it's beginning to rebuild itself, it's going to create new jobs and income is going to go up ... And all those ... metrics are going to start looking better, and so the sustainability of the housing market will be buttressed by that. So that's our main source of reassurance from this." - *Canada was blessed for almost eight decades by a succession of solid, & in some cases inspired, central bank governors; but it looks now as if the incumbent, the third 'outsider' in a row in the Bank's history⁸, may break that tradition. For his comments came in the wake of the Canadian economy in November, for the first time in a long time, experiencing negative job growth (which StatsCan, however, called "statistically insignificant") & the unemployment rate creeping up for the first month in a while,*

⁵ If so, the Alberta government will a **minimum** \$6BN YoY revenue shortfall

⁶ And those who wonder how long Saudi Arabia can sustain its price war may want to take note of its **gross** Debt-to-GDP ratio being <4% & its **net** Debt-to-GDP ratio -53%.

⁷ & whose primary qualification for the job, other than a few years two decades ago as a mid-level Bank of Canada bureaucrat, may have been that, having long aspired to the job, he would be more amenable to the Prime Minister's bidding (who is facing an election within the year), than his predecessors, whose economic credentials & networks had been vastly superior to anything the Prime Minister himself possessed.

⁸ Who came, in contrast to his two immediate predecessors (who were Department of Finance alums) to the post from that of President of EDC (Export Development Corporation); with the Canadian dollar at US\$0.87, he may expect the manufacturing sector to pick up the slack created by the softening energy sector, & the increased Canadian dollar value of their exports to help 'pump prime' the Canadian economy.

the increase in hourly wages & salaries trailing the rate of inflation & the prospect of lower oil prices likely to reduce oil company capex & thereby seriously impact on the Alberta economy (which has been Canada's main job creator in recent years). Moreover, the Bank has for some time been warning of the record high levels of household debt in Canada (which is only the more worrisome since 12% of households account for 40% of it). Finally, according to Moody's the outlook for Canadian provinces continues to be negative, "with pronounced and ongoing weakness in commodity prices posing an economic and fiscal threat to Canada's oil-leveraged provinces" (Alberta, Saskatchewan & Newfoundland) & no fewer than six long-term provincial credit ratings (incl. Ontario, Québec, BC & Manitoba) having a negative outlook. Presumably, coming from EDC, Poloz is counting on the 87¢ dollar to bail out the Canadian economy; if so, he may be leaning on a slender reed indeed. For that same weak dollar will increase the Canadian dollar cost of imports & boost inflation in Canada (both of which will have a far more immediate impact than any increase in the export of manufactured goods).

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US JOB GROWTH SURGES (Reuters)

- The US Labor Department reported on December 5th that in November US employers had created the most jobs, 321,000, since January 2012 (40+% more than the 230,000 expected); moreover, the final data for September & October showed the initial reports had underestimated the number created in those two months by 44,000. November was the 10th month in a row since 1994 that new job creation had exceeded 200,000 (*although then the labour force had been 19% smaller*). But the unemployment rate, at 5.8%, was unchanged (*presumably as more people started/resumed looking for jobs, as suggested by the participation rate being flat MOM at 62.8 (which, while up marginally from September's long-term low of 62.7, was still down 0.2% YoY)*). And average hourly earnings were up 2.1%, & *there is growing anecdotal evidence employers are having problems finding qualified employees & have begun 'raiding' other employers' staff*. This suggests that US economy is weathering the slowdowns in China & Europe, and the recession in Japan, and that the Fed cannot help but get closer to the day it must start raising interest rates, even though the rate of annual earnings growth is still well below the 3% level at which Janet Yellen is said to comfortable starting to do so.

A possible reason not to take the above-noted number not too seriously, that people seem to be overlooking, is that most of the newly created jobs were a) seasonal and/or b) low-paying [although there was also a positive element in the decline, by 177,000, in the number of people (involuntarily) employed part-time]. Meanwhile, StatsCan reported that same day that in November the Canadian economy had shed 10,700 jobs, the unemployment rate had risen to 6.6% from its nearly six year low of 6.5% in October, the participation rate had remained at 66.0% for the fourth month running, and average hourly wages of permanent employees had been up 1.6% YoY, down from 1.9% in October & trailing the rate of inflation.

WILL LAWMAKERS SNEAK A GIFT TO WALL STREET INTO THE SPENDING BILL?
(NYT, Teresa Tritch).

- One key aspect of Dodd-Frank sought to force the big banks to conduct their most speculative (& *potentially most profit-, & loss-, making*) activities in separately capitalized subsidiaries in eligible for deposit insurance & Fed fallback-, or other taxpayer-, support (*to end their 'heads we win, tails you lose' business model*). Needless

- to say, they have fought this tooth & nail & long managed to have regulators to defer the introduction thereof. But now the regulators have indicated there will be no more delays.
- Along the way the House Republicans, with some Democratic lawmaker support, especially those from New York, on several occasions passed legislation to scrap this aspect of Dodd-Frank. But they never came to a vote in the Democrat-controlled Senate & even elicited a (weak) threat from the White House the President would veto any such bill. But now a renewed, *supposedly Citigroup-prompted*, effort by lawmakers from both parties to do away with this aspect of Dodd-Frank is underway, *more perniciously* so since by embedding it in the catch-all federal spending bill they hope to avoid public scrutiny & *make it difficult for the President to veto it*.

This is driven, of course, not by the public interest-, but by Wall Street campaign funding preservation-, considerations. And more banks than just the biggies may now be pressing harder than ever for this. For the fallout from lower oil prices could be seriously detrimental to the financial health of those that lent to (smaller, more leveraged & shale-oriented) oil companies and/or loaded up on their high-yield 'junk' debt and/or accommodated their demand for oil price hedges (a lot of which supposedly for US\$90, or higher), with there being anecdotal evidence some are trying to cut their losses by seeking to buy out the forward contracts involved. And this is rumoured to have led to a split in the Democratic Party, with its left, led by Minority House Leader Nancy Pelosi (D.-Cal), at odds with the President over him agreeing to have it included in the bill, while the Tea Party, that all along has been opposed to deals for Wall Street, finds itself out in left field.

CAN ASHTON CARTER REIN IN A PENTAGON OUT OF CONTROL? (WP, Fareed Zakaria)

- The Republicans launch investigations as to why a few hundred million dollars of taxpayers' money was wasted & insist departments must do more with less. All except Defense which spends US\$600+BN (*one-sixth, give or take, of the federal budget*), employs 1.4MM men & women in uniform & 700,000 civilians, and has 700,000 full-time consultants on its payroll, according to the GAO has run up almost US\$500BN in overruns on its procurement programs (many of them awarded on a non-competitive bid basis & one-third of it on the F-35 program alone), and scrapped plans for a new presidential helicopter fleet when the cost of a single chopper began to get approximate that of a 'jumbo' Boeing 747¹⁰.
- In 1961 President Eisenhower, *in his farewell address on January 17th*, warned against the "unwarranted influence" of the "military-industrial complex"¹¹. And on the 50th anniversary of his doing so John McCain argued it was now more pervasive & corrupt than ever and that, since Congress had become its handmaiden, it now really should be referred to as the "military-industrial-congressional complex". For the Pentagon budget is always replete with 'earmarks', lawmakers' pet projects not wanted by the Administration, that cost billions & waste taxpayers' money, "sometimes for decades", aided & abetted by the revolving door between the Pentagon consultants' & lobbyists' communities. McCain called this "a massive windfall for industry ... but for the taxpayer and the war fighter ... an absolute recipe for disaster." And according to former Defense Secretary Robert Gates¹² in his recent memoirs the Pentagon is a "gargantuan,

¹⁰ Actually this was done by President Obama, not the Pentagon.

¹¹ That some critics have compared to Nazi Germany's commitment to the heavy/weapons industry.

¹² From 2006 to 2011, i.e. two years under Bush 43 & three under Obama.

labyrinthine bureaucracy” that spends 40+% of its budget on overhead, has up to 30 layers between the Secretary of Defense & the action officers¹³, & resembles nothing as much as a gargantuan socialist enterprise with its own rules, shielded from market discipline & accountable to no one.

- Ashton Carter, supposedly President Obama’s choice to succeed Chuck Hagel as Defense Secretary, as Deputy Secretary of Defense from 2011 to 2013 sought to untangle the procurement process, John McCain will soon become Chairman of the Senate Armed Services Committee & his about to become counterpart in the House, Rep. Mac Thornberry (R.-Texas), seems to be of a reformist bent as well. But the best that can be hoped for is that they can win tiny victories; for Secretaries come & go but the military-industrial-congressional complex lives forever.

All over the democratic world all senior bureaucrats worth their salt are masters at the craft of neutralizing the efforts of temporary political masters who threaten their “rice bowl”.

“ONE COUNTRY, TWO SYSTEMS” FALLS APART (Real Clear Politics, Joseph Bosco)

- Taiwan’s *recent* local elections & Hongkong’s public demonstrations send a clear message to Beijing these two peoples don’t want to live under Chinese Communist Party rule. This has been building for years & has put paid to Deng Xiaoping’s prescription of “one country, two systems”. Xi has the latitude & opportunity to use force in Hongkong where the local police appears to have adopted the ruthless behaviour their Mainland counterparts display in dealing with protests. The only question now is if he will risk a Tiananmen Square-like massacre if the locals cannot get a handle on the situation.
- Taiwan presents Xi with a different challenge. A couple dozen countries still recognize the Republic of China. And even those that accept the “One China” concept, incl. the US, have repeatedly insisted any resolution of Taiwan’s fate should be determined by its 23MM inhabitants rather than, as Beijing has long maintained, by the Mainland’s 1.4BN.
- The US Congress in 1979 passed the Taiwan Relations Act promulgating that any threat to Taiwan would be a matter of “grave concern” to the US. Then in 2005 the National People’s Congress passed the Anti-Secession Law which threatened war if Taiwan were to declare independence, or even moved in that direction &, furthermore, reserved the right to use “non-peaceful means” if Taiwan were to take too long to accept Beijing’s rule. And its latest *local* elections may have convinced Xi c.s. that the possibility of closer political ties is vanishing as the likelihood grows that the current, most pro Beijing-ever, Taiwanese government ever will be replaced by the pro-independence Democratic Progress Party in the 2016 Presidential election. Xi now seems to have two options : decide if he now has sufficient justification to take military action against Taiwan or should wait for a more tangible pretext to do so. The outcome will be heavily influenced by his assessment of what Obama might do : will he be so politically constrained at home as to be unable to enter into another military confrontation abroad or will he, politically weakened as he is, jump at the chance to confront a foreign adversary to help this party in the 2016 Presidential Election?

The author retired in 2010 from a position in the Office of the Secretary of Defense where he dealt with Asian matters & now is a Senior Non-Resident Associate & the Sumitro Chair at the Washington-based CSIS (Centre for Strategic and International Studies). While he paints a

¹³ Both the level of overhead spending & the layers of bureaucracy would be totally unacceptable in any self-respecting for-profit enterprise (but neither is all that uncommon in the public sector).

scary scenario, it may have a low probability of coming to fruition. For while the PLA's headcount may be the biggest in the world, its naval- (& to a lesser extent its airforce-) component is likely not up to ensuring a successful outcome of head-on confrontation with the US during the foreseeable future (especially right now since Xi's anti-corruption campaign has the uppermost levels of the PLA in turmoil). Moreover, the 'Umbrella Movement' seems to be foundering on Hongkong's non-student population having grown tired of the disruption it has caused to their everyday-, &, more important, their business-, life.

CHINA DENOUNCES PHILIPPINE 'PRESSURE' OVER SEA ARBITRATION DISPUTE **(Reuters, Adam Rose)**

- On December 6th China denounced the Philippines for putting it under pressure with its request for international arbitration over disputed waters *in the South China Sea* & again refused to participate, one week ahead of the December 15th deadline *set by the Paris-based International Court of Arbitration*, to respond to the charge *by the Philippines*. For in a position paper published that very day the Foreign Ministry postulated "Its underlying goal is not ... to seek peaceful resolution of the South China Sea issue but rather, by resorting to arbitration, to put political pressure on China, so as to deny China's lawful rights in the South China Sea through the so-called "interpretation or application of the UN Convention" (*of the Law of the Sea*). And at a news conference a Foreign Ministry spokesman elaborated "Some people, who do not know the truth, have questioned China's position for not accepting arbitration ... Some others, who harbour ulterior motives, have made one-sided and misleading readings of the rules of international law and, on that basis, made accusations or insinuations that China does not abide by law, and perversely brand China's position a 'challenge to international law'." He also maintained, *with about as much credibility as any of the above*, that the timing of its position paper had nothing to do with the timing of the deadline set by the Court.
- Beijing's participation is not essential. For the tribunal's role is not meant to resolve the dispute but rather to merely address the validity of China "Nine Dash Line"¹⁴ & the ways it interprets the relevant aspects of the Convention (to which it is a signatory).

Its "the best defense is an aggressive offense" strategy implies it expects to have the Court's ruling favour the Philippines. Another reason its arguments are so convoluted, self-serving & ludicrous, may be because it finds itself in what is for it new & unknown territory, having to convince a third party of the righteousness of its case, something with which it has had little, if any, experience.

SENIOR PLA NAVY OFFICER LEAPS TO HIS DEATH (SCMP, Minnie Chan)

- The Deputy Commissar of the PLA Navy Vice-Admiral Ma Faxiang (*promoted only a few months ago to his present post, that deals with officers' promotion & their ideological indoctrination*) was reported to have committed suicide on November 13th by jumping off a building in a Navy complex in Beijing (*it took 23 days before his death, "from an illness", was officially confirmed*). This came ten weeks after Rear-Admiral Jiang Zhonghua of the Navy's South Sea Armaments Department on September 2nd had done the same thing, by jumping from a hotel in Zhoushan, Zhejiang Province (*immediately South of Shanghai*) and a few days after Maj.-Gen Song Yuwen, Deputy Commissar of

¹⁴ That claims virtually all of the South China Sea as its territory, despite the fact that most of it is far closer to other riparian nations than to China.

the Jilin Military District was reported to have hung himself. But, according to a retired naval officer, "compared to the biggest tiger, Xu Caihou, the cases of Ma, Jiang and even Wang (a former Deputy Commander of the PLA Navy who was given a suspended death sentence in April 2007 for embezzling 160MM yuan of public funds) are nothing."

Gen. Xu was, from 2004-2012, one of two Vice Chairmen of the powerful Central Military Commission (headed by Xi himself &, before him, his predecessors), and as such the highest uniformed officer in the PLA & the most senior military figure caught up in Xi's anti-corruption drive. An investigation against him was launched last March, he was expelled from the Communist Party in June, & in late October he was said to have confessed to taking bribes (more specifically he is accused of nepotism & of having promoted senior officers on the basis of the size of the bribe they offered him). Eight flag officers were recently arrested & over 200 senior military officers are said to be under investigation for corruption and/or of having been a member of a graft ring led by Xu. And word has it that the next head to fall will be that of Guo Boxion, the other Vice Chairman of the Central Military Commission (from 2002 - 2012), whom Xu implicated during his interrogations in an attempt to save his own hide - Xi's campaign to cleanse the PLA is long overdue; for it has long been common knowledge many senior PLA officers were (obscenely) wealthy.

POLAND RAISES CONCERNS OVER 'UNPRECEDENTED' RUSSIAN ACTIVITY OVER BALTIC (Deutsche Welle)

- On December 7th Norway reported that one of its war planes had a "near miss" with a Russian fighter aircraft that had ventured too close in airspace North of the country. The next day there were reports of more than 30 Russian aircraft over the Baltic region as well as the interception of two Russian aircraft over the Baltic Sea by Dutch F-16 fighters. All this is putting countries in the region on edge, causing Poland's Minister of Defense on December 11th to express concern over the extent of Russia's recent military action over the Baltic Sea although he maintained "We are not under military attack. These activities don't have the character of preparing for an attack."

Hopefully this is indeed just posturing by Putin. But, even if it is, it can nevertheless lead to incidents with unforeseen consequences. Meanwhile a new ceasefire in Eastern Ukraine appears to have reduced shelling there (although the most recent round of talks planned for December 9th in Minsk, the capital of Belaurus, were canceled without further explanation).