Quote of the week : "When you run any organization you have to look as far down the road as you can" **-** Sir Alex Ferguson, the highly successful manager of Manchester United for 27 years & only professional sports team manager ever to be the subject of a case study at the Harvard Business School - *instead, in recent decades, from the top of the political-, & corporate-, food chain to the level of the average voter/consumer, the focus has been on 'instant gratification', with an all but total disregard for the longer term consequences of today's decisions.*

Declining after-tax profits as a share of US National Income[1] **-** According to the BEA (US Bureau of Economic Analysis) in the nearly 25 years to September, 30th, 2015, this ratio went from 5.8% in January 1990 to 8.7% by mid-1997, declined to 5.5% by late 2001, recovered to 10.0% by mid-2006 & dropped off again to 6.5% by late 2008 and, after climbing to 11.7% by late 2011, as of September 30th, 2015 was 9.8% - *this is not great news at a time that P/E ratios are still at historically rather high levels. Among the factors at play in the most recent earnings compression are the high dollar, rising employee compensation, a lack of corporate 'pricing power' & the low oil prices (although earnings growth in over half the other S&P 500 sectors is also decelerating*)

January's US new job creation - On Friday February 5th the BLS reported that in January 155,000 new jobs had been created & the unemployment rate declined by 0.1% to 4.9%. But really about the only bits of good news were that the 4.9% unemployment rate was an eight-year low (albeit still well above the December 2006 pre-financial crisis 4.4%) & that the participation rate, at 62.7, had remained above the 48-year low 62.5 set last October & November. For 155,000 was well below the 190,000 expected, down MoM from December's 262,000, & the fourth-lowest monthly total in two years. Over one-third (57,000) of the net new jobs created were in the low-pay retail sector, while the 20,300 jobs lost in transportation & warehousing jobs (*hinted at an economic slowdown?*) & the 75,100 layoffs announced in January were up 41% YoY & a seven year high.

Saudi-Russian agreement to 'freeze' oil production at the January 2016 level - It has more holes in it than Swiss cheese. The January supply exceeds demand by about 2MM bbld; so the price-depressing inventory 'overhang' will keep building. While it is contingent on others agreeing, on February 17th Iran's Oil Minister Bijan Zangaweh welcomed the idea but wouldn't commit to capping his country's oil production. Iraq is waffling. Venezuela, while part of the group promoting a freeze, can be expected to cheat since it needs money desperately (as does Nigeria). And on February 18th Russian Deputy Minister of Energy Kirill Molodtsov told reporters "We have reached agreements with OPEC to keep production at January's level. As of January 11 the increase in production was 1.9%." And the market rendered its judgment when the oil price declined on the news.

US oil company bankruptcies - According to the Haynes and Boone[2] Oil Patch Bankruptcy Monitor 42 *small* US oil companies went TU in 2015, owing US$17BN, close to half of it unsecured. One thing people forget is that in bankruptcies producing assets don't disappear; they just move into new hands with deeper pockets without the crushing 'legacy debt'; so he new owners have lower operating costs & can keep producing (*if not expand output*), even at still lower prices.

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1 It differs from GDP (that represents the value of all goods & services produced) in that it is net of the cost of the capital consumed in producing those goods & services (i.e. depreciation).

2 A Dallas, Texas-based corporate law firm with offices in four other US states, as well as in Washington, D.C., Mexico City & Shanghai.

Why the oil price slump has been deeper, & may last longer, than many expected - There has been much talk about the inevitability of break-even prices forcing output cuts. But these prices have two components : *sunk* capital-, & *ongoing* operating, incl. interest payment-, costs. And as long as the latter are covered, producers are generating positive cash flow, & have little or no incentive to cut output (& risk the future cost of rehabilitating their production infrastructure at a later date). Following is an estimate by Oslo-based oil & gas consultant Rystad Energy of the cost structure of the Middle Eastern OPEC members, and Russia & Venezuela :

	Capital Cost	Operating Cost	Total Cost	Net Cashflow/bbl at US$30	US$60
	US dollars				
Kuwait	4	5	9	21	51
Saudi Arabia	5	5	10	20	50
Iraq	6	5	11	19	49
UAE	7	5	12	18	48
Iran	7	6	13	17	47
Russia	9	8	17	13	43
Venezuela	10	14	24	6	36[3]

Anyone who has ever taken Economics 101 had the Law of Supply & Demand drummed into his/her head : a lower price for a product will result in more demand & less supply until a new equilibrium has been established. But obviously the oil market isn't aware of this. For in the year ended June 30th, 2015 global demand for oil grew by 1.4%, only 0.1% faster than in the year-earlier period, as the oil price declined 45%. And ditto on the supply side; following are some production numbers (in 000's of bbld) as of June 2014 & October 2015 : OPEC 31,981 & 33,625, Angola 1,663 & 1,810, Ecuador 555 & 538, Egypt 510 & 509, Iran 3,100 & 3,300, Iraq 3,325 & 4,275, Kuwait 2,650 & 2,550, Libya 235 & 415, Mexico 2,450 & 2,314, Nigeria 2,420 & 2,370, Norway 1,744 & 1,946, Qatar 1,553 & 1,537, Russia 10,000 & 10,140, Saudi Arabia 9,690 & 10,140, & UAE 2,820 & 2,820.

In the short run only two things can (temporarily?) bump up prices : a serious East-West military confrontation in the Middle East, or a major terrorist event there or in the developed world.

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Thursday February 18th, 2016

CENTRAL BANKS HIT A WALL (G&M, David Rosenberg)

- In many respects the global economy (*???*) & the US banking sector in particular are now in better shape than seven years ago when US home values & the financial system were imploding. But markets are signaling concern over the one issue never addressed *in the interval* - that of excessive indebtedness. The lack of meaningful growth in global GDP has rendered the ability to service it more dubious than seemed possible even a few months ago, & confidence waning fast. For the world is still awash in debt; in fact the global debt-to-GDP ratio now is higher, 290% vs. 270%, than before the financial crisis.

[3] Small wonder Venezuela is so anxious to get the price of oil back up; for, while having it rise to US$60 would hike Saudi cash flow 'only' 2½ times, but increase Venezuela's six-fold!

- There are fewer policy arrows in the central banks' quiver than in 2008. Its growing lack of credibility is demonstrated by the fact the futures market isn't pricing in any Fed rate hike until November 2017. While in 2009 central bank action could bolster markets, the law of diminishing returns has set in &, while their latest experiment with negative interest rates is going nowhere, the central banks seem disinclined to back away from policies that are undermining the banking system & thwarting the quest for faster growth.
- The problem stems from fiscal policies that depress economic growth rather than utilize the dramatic increase in monetary stimulus to end the growth malaise. With the central banks now 'hitting the wall', we need fiscal policies that, finally, work in consort with monetary policy, *rather than download the entire burden of economic management on it.* Unfortunately, this would require *a degree of* political will that has long been MIA.

He doesn't say how much scope developed country governments, with their aging populations & debt-to-GDP ratios in-, or zeroing in on-, the triple digit range, may have to provide fiscal leadership, even if the political will to do so existed - Born & educated in Canada (UofT), he was Merrill's New York-based Chief North American Economist until 2009 when, after the Bank of America bail-out, he decamped to the market's 'buy side as Chief Economist at Toronto-based money manager Gluskin Scheff. He has long been a 'the glass is half-empty' sort of guy with, however, a better-than-average forecasting track record, & is always worth listening to.

GOLDMAN CLIENTS HAVE GLOBAL CONCERNS (Bloomberg)

- According to its Chief US Equity Strategist David Kostin "Fund managers are fearful that negative animals sprits have taken hold in the global economy ... More than one-third of the clients attending our recent macro conference in Hong Kong expect cash will post the highest risk-adjusted return of any asset class in 2016 ..."

This is saying something when cash has a negative yield on both a nominal-, & real-, basis.

ONE-THIRD OF OIL COMPANIES COULD GO BANKRUPT THIS YEAR
(Fortune, C. Zillman)

- A February 16th report by Deloitte concluded, after examining 500 publicly-traded oil & gas E&D companies worldwide, that, after losing the shelter provided by the hedges on their 2015 output, one-third of them, with total indebtedness of > US$150BN, are now at 'high risk' of going bankrupt this year, but that oilfield service providers are in a slightly better position since they have lower capital costs (*& marginally greater pricing power?*)

Few companies in any industry can long withstand a 70+% drop in their product's selling price; in this case hedging has only postponed the day of reckoning (to a more inconvenient time?)

U.S. HOUSEHOLDS RAMP UP SPENDING (Reuters)

- After slowing to a crawl in late 2015 US consumer spending regained momentum in January as households boosted their purchases of a range of goods, prompting Paul Ashworth, the Toronto-based Chief North American Economist for London-based Capital Economics to declare "The markets may have decided that the U.S. is headed for recession, but obviously no one told U.S. consumers." On the other hand, the outlook for consumer spending was tempered by a report on February 12th that *the Michigan* consumer sentiment *index* had ebbed *MoM* in early February *to 90.7 from 92.0.*

Consumer spending in January, ex autos, gasoline, building materials & food services, was up 0.6%, twice the 0.3% expected & a radical reversal from the 0.3% decline in December. Meanwhile, Fourth Quarter GDP growth clocked in at just a 0.7% annual rate on slow consumer demand, inventory liquidation & weak capital goods' spending, January consumer spending was up just 2.6% YoY, and the 90.7 consumer sentiment reading was at the lower end of its past year's 87.2 - 96.1 range. Meanwhile, the Atlanta Fed's GDPNow real time forecast (that, at 0.6% vs. 0.7% had been almost spot-on for the Fourth Quarter), and that had rocketed from 1.1% to 2.7% in th the first two weeks of this month, at last report had softened a bit to 2.6%.

<u>POLL FINDS STRETCHED HOUSEHOLDS</u> (Canadian Press)

- Edmonton-based <u>MNP Debt</u> provides licensed trustee-, *debt consolidation-, & bankruptcy-*, services in the six provinces from Québec West. Between January 27th & 29th Ipsos-Reid conducted an online survey of 1,582 people for it on their financial situation; it found that one-quarter was unable to cover their bills & make their debt payments, that others were within $200 of not being able to do so, & that 31% said that any increase in interest rates could move them towards bankruptcy.

Even if it were only remotely close to reality (& in Alberta the situation is likely worse), this would be scary. But its findings are consistent with another poll last May that found that over half of Canadian households do not save money on a regular, ongoing basis.

<u>ECONOMISTS AXE FORECASTS FOR GROWTH</u> (G&M, David Parkinson)

- At a pre-budget consultation session on February 12th Canada's top private sector economists warned Canada's Finance Minister Bill Morneau about their dramatically reduced economic growth expectations since his fiscal update last November.

But there was no consensus among them what the Budget should/could do about this.

<u>WHAT HAPPENS NEXT IN ALEPPO WILL SHAPE EUROPE'S FUTURE</u>
(The Guardian/Le Monde, Natalie Nougayrède)

- The Assad regime's assault on Aleppo is a defining moment for relations between the West & Russia whose airforce is playing a key role in it. For the defeat of the anti-Assad rebels who have partially controlled this city since 2012 will leave no one on the ground in Syria but Assad & the Islamic state, and ends all hopes of a negotiated settlement. It was no coincidence this attack was launched on the eve of peace talks in Geneva *that fizzled before they even could start*; for this was Putin's way of ensuring the rebels would not get any say in Syria's future & of trying to undermine the strategic global position of Europe, & of the West in general, by exploiting its leaders' decision-making vacillations.
- A defeat for the Syrian opposition forces will strengthen ISIS' claim of being the sole defender of Sunni Muslims there. While Putin claims he is fighting ISIS, in Aleppo he is helping to destroy the only Sunni element fighting ISIS[4]. But his strategic objectives go much further; in reasserting Russian influence in the Middle East, he is really targeting

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4 Which is not quite correct. For the Kurds have done likewise & been more effective at it; but while they may be Sunnis, they are not Arabs : they speak a different language & have different cultural habits Thus their women don't cover their faces & have fewer restraints put on them (the two sexes mix freely socially & in the work place) and they have an agenda of their own (that does not include being part of Syria, or, for that matter, of any other country : they want one of their own!).

Europe, with the deciding moment having come in 2013 when Obama didn't follow through on his 'red line' threat if Assad used chemical weapons against his own people.

- NATO is in a bind; for one of its members, Turkey, has a direct interest in the outcome of the Syrian situation & any lack of cooperation on its part in dealing with the refugee problem serves Putin's purposes by boosting the fortunes of Europe's anti-refugee populist right-wing parties, hiking the probability of a Brexit & weakening Angela Merkel. He benefits from the chaos in Syria at Europe's expense & getting him to change will take more than *words or* wishful thinking; while Aleppo is an unfolding human tragedy, there is a link between its plight, the future of Europe & Putin's strategic objectives.

The writer (age 49) is French-born & educated but spent part of her youth abroad, incl. Britain & Canada. She worked for 16 years prior to 2014 for Le Monde (*culminating in a brief stint as its Executive Editor) where she developed a reputation for asking the questions others were too discrete to ask & voicing opinions that ran contrary to the CW.*

IRAN SHIPS FIRST-POST SANCTION OIL TO EUROPE (World Maritime News)

- Pirouz Mousavi, Managing Director of IOTC (Iranian Oil Terminals Company) announced that three oil tankers had on February 14th berthed at the Kharg Terminal, in 48 hours had been loaded (with 4MM bbls of oil), & were on their way to Europe. One with 2MM bbls was destined for refineries owned by France's Total, and the other two with 1MM bbls each for Spain's CEPSA (Compa ia Espa ola Petróleos) & a Lukoil-owned refinery in Constantza, Romania. However numerous uncertainties remain before Iran can return 'in full scale' thus according to Iran's Oil Minister his country needs US$200BN in foreign investment to modernize its oil infrastructure (*with European businessmen slavering at the thought of getting a piece of that action).*

While there were reports earlier of Iranian oil landing in Europe,that had involved oil that had been in storage in tankers at anchor, whereas this involved newly-loaded oil.

CHINA'S CENTRAL BANKER SEEKS TO DEFUSE MAKET JITTERS (G&M, Brian Milner)

- Zhou Xiao-chuan (age 68) has headed the PBOC for 14 years. After letting his deputies do the talking for six months (*to the point where people thought he was dead*), he came out of the shute over the February 12th weekend in an interview with the influential business weekly Caixin with a detailed, 'good news' assessment of China's current situation & its capacity to weather any financial storms. This came only a few days after Dallas-based money manager Kyle Bass (who made a bundle in 2008 shorting the subprime mortgage market *but whose track record as been unremarkable since*) sent a 12-page letter to investors saying China's banking system was a "ticking time bomb" & faced loan losses 4x those of the overleveraged US banking system in 2008.

His warning, George Soros' observation that China faces a "major adjustment problem that reminds him of the 2008 crisis", & a comment by another well-known short-seller, Jim Chanos, that China is on "a treadmill to hell" haven't sat well with the Chinese authorities.

LEAVE TO REMAIN - YOU SHOULD HEAR WHAT THEY SAY ABOUT US (lordashcroft polls. com, Lord Ashcroft)

- As David Cameron heads to Brussels to finalize new EU membership terms, knowing that, while some fellow citizens could never be persuaded to stay, others can be swayed if they thought he had gotten a good deal, following are the views of 28,000 Europeans on Britain. Sixty percent want it to stay, 30% say it doesn't matter if it stayed or left, & ten percent wants to be shot of it. They rate Britain second only to Sweden in their "favourability ratings". Many see Britain as standing up for itself, as a country with military clout & as the EU's third-most influential member (after Germany & France) but are concerned a Brexit would be a blow to EU prestige & possibly trigger other departures. While many don't like the idea of the UK being exempt from participation in Eurozone bailouts & from "ever closer union", changes to welfare rules & more powers for national governments were non-controversial, provided they would apply equally to all. While not starry-eyed about the institution & complaining about unnecessary rules & regulations (& those in the North about having to pay for other countries' economic problems), they are more inclined than British voters to consider this the 'price of admission'; for many see the EU as enhancing the role Europe can play in the global community & as a way to end the *semi-permanent* state of conflict that has prevailed in Europe for centuries (thereby having an emotional attachment to the EU that's absent in the British people).

The vote could be close; at last report (February 15th) the polls, for all they are worth, were calling it 51% STAY vs 49% OUT, down from 55-45 a month earlier (& well within the range of the 'margin of error' for a voter sample this size) - Lord Ashcroft (age 69) is a former Conservative Party Deputy Chairman, a life peer & self-made billionaire (his £1.3BN net worth makes him the 74th richest person in the UK) who made his fortune buying, sorting out & selling under-performing companies, and whose dodgy tax status has been a matter of controversy. And he is seemingly no admirer of David Cameron, at least his biography of the man last fall has been called a "Jacobean revenge biography", what ordinary folk would call a "hatchet job".