The Week in Review - Gleanings 663

by Nick Rost van Tonningen

June 17, 2016

You will all be glad to hear Nick is sounding very much on the mend after his accident and has resumed, after a two month recuperation, Gleanings where he left off!

Welcome back, Nick, we missed you.

PERSONAL UPDATE - As many of you may already know, the recent two-months' break in Gleanings was due to the fact that on April 16th I crashed my bike. This sent me to hospital for four weeks with a baker's dozen of bone fractures from head to toe up & down my left side and a shaken-up cranium content (I wasn't wearing a helmet), with the most serious fractures being in my pelvic area around my left hip socket (things being complicated by the multiple myeloma I have lived with for the past 14 years having softened my bones to the point where they couldn't use screws. staples or pins to fix any breaks). The first ten days in hospital are a total blank memory-wise but I apparently was a very difficult patient (& I have vague recollections of not knowing where I was & not appreciating what people were doing to me[1]). Following two more weeks at a rehab facility I was discharged on June 2nd & am at home. While upon discharge from rehab I was told to use a two-wheel walker & avoid putting any weight on my left leg, I saw the surgeon involved on June 7th & she told me I could put put more weight on it and be guided by the pain/discomfort level. So, with physio twice a week & daily exercises at home, I expect to be back on my own two feet by late summer. George Burns once observed in Oh God, Part II that for every front there has to be a back, for every up a down & for everything bad something good. In this case the good was that it made me more aware than ever how great my kids really are.

I am still a bit slower than before in getting Gleanings organized, for my head is still not quite 100%, but this too will pass & I expect to be back to the routine of getting it out on a regular Thursday night/Friday morning (Edmonton time) basis, with the occasional Special Edition overnight Monday.

Quote of the week – "Donald Trump is what Americans aspire to be - rich, powerful, do what you want to do, say what you want to say" – O'Shea Jackson, also and better, known as the multi-millionaire rapper Ice Cube.

Brexit - While the latest polls give the LEAVE side a seemingly all but unassailable 55-45 *lead, the* London bookies' odds still favour the REMAIN side; in other words, those whose financial balls are on the line (*but whose thinking may be affected by their location, London is, after all, a bastion of support for the REMAIN side*) expect a radically different outcome than those who got the outcome of the last UK election dramatically wrong & whose financial wellbeing will be less directly affected by the outcome of the referendum, but who have the benefit of a more nation-wide perspective. In the end, the outcome will depend on whether the 15% or so still undecideds will listen to the their head (i.e. the macro-economic argument) or their heart (the anti-immigration one) - *be all that as it may, the importance of Brexit may have been blown out of proportion by the media; for it is a mere byplay to the much more critical issue as to whether the EU ,as it has evolved over the years[2], can survive the refugee onslaught that has revealed the existence of deep fissures between its members of long-, & those of more recent-, vintage; for it has already killed of one of EU=s crowning* *achievements, the Schengen Treaty (that provided for the free movement for member country citizens throughout the EU) that now appears as dead as the proverbial dodo bird (giving Moscow an opportunity to fish in the resultant muddy waters?).*

Total unfunded debt of the US government - According to Boston University's Lawrence Kotlikoff & Asset Builder's[3] Scott Burns[4], it is approaching US$200TR (*10x the official estimate of US$19,230,634,229,700)* of which amount, they say, about US$25TR is accounted for by the unfunded liabilities of the Social Security system. In 2004 the MIT Press published a book by these gentlemen entitled The Coming Generational Stormthat, based on the premise that by 2030 77MM more Baby Boomers will have have entered their old age, walkers for *old people will* outnumber baby strollers *&* that there will be twice as many retirees but only 18% more workers. So they raised concerns about the ability of American society to handle such a "demographic overload" & warned that if the US government were to continue on its then policy course (*which hasn't really changed in the 12 years since*) the result would be skyrocketing tax rates, drastically lower *public* retirement - & health - benefits, and political instability.

The spread of zero interest rates - About 2TR-worth of government bonds now trade at negative yields. In Switzerland the yield on government bonds is now negative right out to the 20-year maturity (& that on 30-year bonds a mere 0.1%)[5]. The corresponding numbers for some of the other 11 European countries with negative yields on government bonds are Germany 9 years & 0.62%, France 7 years & 0.77% & Italy 3 years & 2.41% (*the latter a function of the dreadful fiscal position of its government*). And the negative yield phenomenon has now spread to 16BN of European corporate bonds.

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Thursday June 9th, 2016

U.S. HIRING >UNAMBIGUOUSLY TERRIBLE= (G&M, Joanna Slater)

On June 3rd the U.S. Labor Department's monthly job creation report noted that in May only 38,000[6]new non-farm jobs had been created, a six-year monthly low, and, *to make matters still worse*, revised the corresponding figures for March & April downward (from 208,000 to 186,000 & from 160,000 to 123,000 respectively), but that *nevertheless* the unemployment rate had declined from 5.0% to *a post-November 2007 low of* 4.7%[7]

Wall Street had expected 162,000 new jobs & a 5% unemployment rate. The participation rate in May was 62.6%, slightly greater than September 2015's 62.4% four decade low, but well off the 63.0% to which it had recovered by last March.

CLEAN ENERGY JOBS SURPASS OIL AND GAS FOR THE FIRST TIME IN U.S. (Bloomberg, Anna Hirtenstein)

A March 25th report by Abu Dhabi-based IRENA (the International Renewable Energy Agency) noted that in 2015 the number of US jobs in the solar energy-, had overtaken that in the oil & gas-, industry[8], Furthermore, that employment in the US solar business had grown 12x faster than overall job creation, in part due to innovative financing initiatives by companies such as Solar City that have caused developers to add new workers at record rates to install rooftop panels.

While Solar City's growth may be slowed by Arizona following Nevada's example of sharply cutting the price power utilities must pay for excess power generated by home owners, this may not put much of a crimp in the growth of the US solar power-generating; for California alone installed 3.27GW of new solar power-generating capacity in 2015 (& another 1.67GW *in the First Quarter of this year). And an April 2014 report by McKinsey entitled The Disruptive Potential of Solar Power suggested that those who believe that solar power can only be economically viable with huge government subsidies are behind the times in their thinking.*

“NIGHTMARE” SUPERBUG FOUND IN PENNSYLVANIA (WP, Lena H. Sun)

In April a 49 year-old Pennsylvania woman was the first person ever found in America to carry a strain of E.coli resistant to colistin, the antibiotic of last resort in the fight against nasty types of superbugs [incl. a family of bacteria known as CRE that health officials call the Anightmare bacteria & the CDC (Centers for Disease Control and Prevention) one of the US “most urgent public health threats”]. According to CDC Director Tom Frieden this “basically shows ... the end of the road isn’t very far for antibiotics”.

This has long been in coming, in part due to decades of the irresponsible overuse of antibiotics in treating minor infections & its use as a “precautionary” measure in animal feed, and in part because the drug industry has devoted little of its R&D resources to developing new antibiotics.

RIDING THE RESOURCE SECTOR REBOUND (G&M, Ian McGugan)

The Bloomberg Commodity Index that tracks the price of 22 raw materials, on June 6th was up over 20% from its January 20th low. This shook the Canadian stock market out of the lethargy brought on by last year’s commodity price slump & made it YTD one of the world’s best-performing stock markets, with the rise in the S&P/TSX Composite Index led by a 43% gain in the materials sector & an 18% advance in energy stocks. There were only three non-resource names among the top 40 performers in the index, two of which, Calgary-based Transalta & Vancouver-based Westshore Terminals have significant *indirect* exposure to commodity prices.

A disproportionate share of the rise in the Bloomberg Index was due to the 75% rise in Brent crude & 61% rise in WTI, and the heavy (11.9%) gold weighting (the rise in the price & weighting of the industrial metals & agricultural commodities was typically in just the single digit range) – This wasn’t quite correct, the Peruvian stock exchange outperformed the TSE by a factor of 2.

MINER PREDICTS SURGE IN SILVER PRICE (Bloomberg, Natalie Obiko Pearson)

In April a major Japanese electronics maker approached Vancouver-based First Majestic Silver Corp. to lock in a supply of the metal. This prompted Keith Neumeyer, First Majestic’s CEO, to note “For an electronics manufacturer to come directly to us ... tells me something is changing in the market ... I think we’ll see three digit silver.” More specifically he expects its price to surge to US$140 an ounce by as early as 2019.

This is a bold forecast indeed. For, *after decades of trading at < US$10/ounce,* silver hit a near-record US$50 in 2011 & was US$17.36 on June 9th, and the most optimistic forecast among analysts recently surveyed by Bloomberg was for US$57 by 2019. And according to Dan Denbow, a portfolio manager at San Antonio-based USA Precious Metals & Minerals. “That (*i.e. US$140*) seems aggressive ... There has been a lack of interest in silver exploration[9], but with significantly higher prices you will get new supplies”.

Nevertheless there are reasons for optimism. In May hedge funds increased their bullish bets on silver to record highs. It has not just appeal as a store of value but has many industrial uses (*that account for 60+% of its "disappearance") that have now expanded beyond electronics (cell phones, flat panel TVs, and alloys & solders) to home insulation materials & solar panels (but usually in small enough quantities that its users are relatively price-insensitive). And like gold, for years demand has outstripped newly-mined supply and low interest rates reduced the opportunity cost of holding it as a store of value.*

First Majestic operates five silver mines in Mexico & is second biggest silver producer in the world's largest silver-producing country. If the price of silver were to strengthen, one way to benefit thereof would be by investing in a so-called "precious metal streaming" company[10], with TSE-listed Silver Wheaton being the biggest with greatest exposure to silver.

LARGE BANK RISK: LIQUIDITY, NOT CAPITAL, IS THE ISSUE
(Kroll Bond Rating Agency, Chris Whalen)

Since 2008 financial regulators have been pushing to boost the large banks' capital bases, despite the fact the 2008 financial crisis wasn't caused by banks lacking capital. The problem with doing this so as to avoid future rescues of "too-large-to-fail" banks is that it doesn't address the real cause of the 2008 problem, namely activities by the banks that undermined investor confidence (*& led to a lack of mutual confidence among the banks themselves*). While the powers that be believe, erroneously in our view, that higher capital levels will help avoid future bank failures & the need for public bailouts of large banks, we see no evidence that higher levels of capital would have prevented the *run on liquidity* that, starting in 2007, caused a number of depositories & non-banks to fail.

They may be onto something. For the central banks' low/zero interest rate policies have led to a (mindless) search by lenders & investors alike for yield, with little or no regard for risk, in instruments that often have, even at the best of times, very limited liquidity.

ISRAEL WAGING WATER WAR ON PALESTINIANS (al-Jazeera)

- A statement issued on June 16th by the office of Palestinian Prime Minister Rami Hamdallah said that Israel is "waging a water war against Palestinians … uses its control over our water resources to this end … while illegal Israeli settlements enjoy uninterrupted water service, Palestinians are forced to spend great sums of money to buy water that is theirs in the first place." Two days earlier Ayman Rabi, the Executive Director of the Palestinian Hydrology Group, an NGO focused on water-, & sanitation-, issues, told al-Jazeera that "some areas had not received any water for more than 40 days" from Mekorot, Israel's national water company, the main water supplier to Palestinian towns & cities (charges the company denies, saying that there was only a broad reduction in water supply to the Palestinians) and that "People are relying on purchasing water from water trucks or finding it from alternate sources such as springs and other filling points in their vicinity … Families are having to live on two, three or 10 litres per capita per day." (according to the UN 7.5 litres per person per day is the minimum requirement for most people under most conditions but in some areas of Palestine – where temperatures exceed 35 degrees Celsius – the minimum requirement is much higher).

International statistics show that Israeli water consumption is 350 litres per person per day range but that of West Bank Palestinians just 60 litres. Part of this is due to the fact that under the interim peace agreements signed two decades ago Israel is entitled to 80% of all shared resources & the Palestinians just 20% (while today the West Bank Palestinian population is about one-third Israel's. And while at last report about 40% of Israel's water *supply comes from its four desalination plant, what really rots the Palestinians' socks is that the Jewish settlements in the West Bank sit astride the West Bank's major aquifers.*

SOROS SAID TO RETURN TO HANDS-ON TRADING, SEES MARKET SHIFTS (Bloomberg, Andreea Papuc)

According to an insider, octogenarian George Soros, concerned about the outlook for the global economy & the risk that major market shifts may be in the making, has resumed more direct involvement in the day-to-day management of Soros Fund Management LLC, his personal wealth management firm. He believes that a "hard landing" in China is "practically unavoidable" and will worsen global deflationary pressures & drag down stock prices. According to the latest quarterly government filing, the firm engaged in a series of big bearish investments, cutting its US equity portfolio by one-third & hiking its direct & indirect exposure to gold. Soros takes a dim view of the world economy and of China in particular, whose debt-fueled economy he compares with that of the US in 2007-08 (when credit markets seized up, prompting a global recession). In his opinion, most of the credit Chinese banks have been extending has not been invested productively but gone to support bad debts & keep loss-making enterprises, *many of them SOEs*[11], afloat.

In 1973 Soros was the co-founder, with Jim Rogers, of the Quantem Fund, the first ever serious hedge fund (that he wound up in 2011). He "made his bones", & an estimated US$1+BN, in 1992 when he locked horns with the Bank of England, short selling sterling & forcing its devaluation, and in 1997 was blamed for having engineered the devaluation of the currencies of several South-East Asian countries (leading to what is commonly known as the 1997 Asian Financial Crisis). He obviously has not sat still since; for at last report his net worth was US$23.9BN (making him the 15th richest American & the 23rd richest individual worldwide).

THE $34 TRILLION EXPERIMENT: CHINA'S BANKING SYSTEM AND THE WORLD'S LARGEST MACRO IMBALANCE (Hayman Capital Management LP, J. Kyle Bass)

The unwavering faith that China can head off a severe economic slowdown by endless credit expansion reminds us of the 2006 belief that US house prices would never decline. Chinese banks' assets grew from US$3TR (*1.2x GDP*) to US$34TR (*3.4x GDP*) in the decade ended in 2015 & its loan losses, the growth of which has started accelerating, "could exceed 400% of the US banking losses during the subprime crisis" *in the not too distant future.* Today China's banking system can no longer support massive growth. No matter how one analyzes the available data, China's economy has already started to experience a hard landing. Earlier this year the National Bureau of Statistics reported that China's migrant population (those who left their hometowns to seek employment or education in cities elsewhere in the country) last year had shrunk by 5.7MM *to 247MM*, the first decrease in 30 years, due to a slowdown of job opportunities in urban centres. According to Goldman Sachs, industrial production has plummeted, with its annualized growth rate having gone from almost 40% in 2009 to -6% in 2015 (only the third time it has been in negative territory in the past 30 years - the other two being the -10% recorded 1990 & 2009). Steel prices have dropped by 60% since 2016, and at last report, annual losses at the country's loss-making enterprises (*many of them SOEs*), that must be funded by the banks, have since 2011 increased five-fold to US$1TR (*i.e. roughly 10% of* GDP). We believe the PBOC would have to print US$10+TR yuan-equivalent to recapitalize its banking system, in the process weakening the yuan by as much as 30% vis a vis the US dollar (*which would boost the competitive position of Chinese exports*).

Last January 28th S&P issued a largely ignored report, China=s Banks Face Rising Risks From a Slowing Economy and Government Policy, that pointed out the metrics of the Chinese banking system were rapidly deteriorating, two excerpts of which say it all :

> "We expect more negative ratings this year on Chinese banks";
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> "Deterioration in banks' asset quality is likely to accelerate in 2016. Credit distress (*to date?*) has been from a few segments that private companies dominate - such as wholesale and retail trade, export-oriented light industry, ship building , and coal mining - *but has now spread* to broad-based manufacturing industries where large firms (*many, if not most, of them state-owned*) are common".

While China is held to have massive amounts of foreign exchange reserves, at last report they were US$3.2TR, down from a peak of US$4TR & declining at a US$100BN monthly rate. Using a formula used by the IMF to calculate a country's exchange reserve adequacy, they now are just US$500BN in excess of the US$2.7TR number that it throws up as the minimum "working capital" needed by a country of the size & with the make-up of its economy; so if one nets out the US$700BN held by the CIC (China Investment Corporation) in the country's sovereign wealth funds, China's reserve position "is already below a critical level of minimum reserve adequacy".

Hayman Capital is a Dallas, Texas-based firm Kyle Bass founded in 2005. A contrarian, in 2007 his fund had a 212% return due to him having shorted the sub-prime mortgage phenomenon. But since they have averaged < 2% annualized. While his pre-occupation with China may be driven by a dream of finding another "ten-bagger", he does make some seemingly valid points.

LONDON ELECTS FIRST MUSLIM MAYOR (G&M, Mark MacKinnon)

On May 6th London elected its first-ever ethnic minority/Muslim Mayor. Sadiq Khan (age 45) is the fifth of the eight children of a London bus driver & his seamstress wife, both of Pakistani origin, and before entering politics was a human rights lawyer. Not a graduate of an elite school like Eton (as were both Boris Johnson, his predecessor, or his runner-up Zac Goldsmith, a multi-millionaire Conservative, whom he beat 44-35), he is a Ernest Bevin College alum, an inner city secondary school best known for its soccer, and/or snooker, playing alums. His success as a Labour Party candidate was in sharp contrast to the party's poor showing in local elections elsewhere in the UK (thus in Scotland, long a Labour stronghold, it ran third, after the Scottish National-, & the Conservative-, parties), But he no doubt benefitted from the growing ethnically mixed nature of London[12] and from his promise to freeze subway, & bus, fares during his four-year term (while Mr. Goldsmith alienated voters when in a press conference he couldn't name some stations on the London Underground's Central Line (that carries 4MM passengers daily).

As mayor, Mr. Khan, who once described himself in GQ magazine as "a dad,...husband, Londoner, Asian, British, Muslim", is expected to provide London with a radically different kind of leadership than the often outlandish, headline-seeking Boris Johnson (who was motivated to give up the mayor's job by his long-held dream to be Prime Minister).

IN VENEZUELA, CRISIS, ECONOMIC CHAOS AND THE SPECTRE OF A COUP (Toronto Star, Marina Jimenez)

The government can't pay for imports & is operating its schools & public services on a part-time basis only to save water & electricity[13]. Hospitals can hardly function, with several newborns recently having died when the respirators in one hospital's maternity ward shut down due to a power black-out. With even corn flour, milk, antibiotics & blood pressure medication in short supply, and according to the local polling firm Datanalisis, a scarcity factor of 82% in Caracas supermarkets (i.e. shoppers can expect to find only two out of every ten items on their shopping list on store shelves) Venezuelans have reached their breaking point. On June 7th, in the fourth such event in as many weeks, thousands of opposition supporters chanting "I am hungry" marched on the Presidential Palace in Caracas demanding the ousting of President Nicolas Maduro, only to be turned back by the police with tear gas when they came within half a dozen blocks of their destination.

With the opposition Democratic Union coalition, that gained control of the National Assembly in last December's elections, seeking to have President Maduro recalled, the economic crisis has been compounded by a spiraling political crisis that could engulf the entire hemisphere. Thus Luis Almagro, the Head of the OAS, has called Maduro "a petty dictator" & invoked its democratic charter to suspend Venezuela's membership in the 35-country body, prompting Cuban President Raul Castro to call the OAS "an instrument of imperialistic domination" & announce that his country would no longer participate in it.

Coca Cola has had to shut down its operation due to a lack of imported sugar. Inflation is in the 200+% range. According to the Venezuelan Observatory of Violence, a local economic monitoring group there are at least ten food looting incidents a day. And the Maduro clique would prefer losing power in a coup, rather than through a popular vote, since it would then be able to claim to have been the victim of a plot, rather than rejected by its own people.

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[1] Partly due to the fact that I didn't=t have a clue what was going on, possibly due to the drugs I was on; my No.1 on & I had a good laugh the other day when he told me that during one of his early-on visits to me in the hospital, I had confided in him that I was where I was because I had "been abducted by Nazis".

[2] The 1950s "Founding Fathers" of the European integration concept (Germany's Konrad Adenauer, Italy's Alcide de Gasperi, France's Jean Monnet & Robert Schuman & Belgium's Paul-Henry Spaak) were motivated by their WW II experience, as were the hoi polloi of the initial six countries (Belgium, France, Germany, Italy, Luxemburg, the Netherlands) that had joined forces in the Benelux & the ECSC. But while initially there had thus been a great deal of grass roots support for European integration, that was increasingly lost as Brussels-based Eurocrat empire builders became more entrenched & the European integration idea became more "top-down driven", a trend that gained momentum as the EU expanded, first into Southern, and then Central & Eastern, Europe. So, according to the Pew Research Centre, since 2007 public approval of the EU has declined in Spain from 80% to 47%, in Italy from 78% to 58%, in France from 78% to 38%, in Germany from 58% to 54%, and in the UK from 54% to 44%. The overriding sentiment in the EU, as it appears to be in the US, is "Take back control" (from an elite that has benefited from the way the system has operated more than have the hoi polloi (who in the final analysis have far more votes).

[3] An SEC-registered investment advisory firm based in Plano, Texas, 20 miles Southeast of Texas, founded a decade ago by Scott Burns & former Microsoft executive Kenneth Grose.

[4] A 1962 MIT alum in humanities & biology he was a newspaper columnist & financial editor until he retired from the Dallas Morning News in 2006. He is also the creator of the Couch Potato Portfolio strategy of investing 50% of one's assets in an S&P index fund & the rest in a bond index fund.

[5] With the corresponding numbers in Japan being 10 years & 0.3%

[6] The net of 139,000 new part-time jobs, and the loss of 100,000 full-time ones.

[7] Because it calculates the rate on the basis of the number of people with jobs, and/or **actively** looking for work (which 664,000 of them had quit doing during the month).

[8] This was, of course, helped by the fact that global employment in the oil & gas industry has declined by over a third of a million since mid-2014.

[9] Which may, or may not be relevant, for as much as 70% of all newly-mined silver is produced as a by-product in the mining for other metals, incl. gold, copper, lead & zinc.

[10] These companies pay cash up front for a mine's future output at a fixed, well below current market, price. They have expanded their portfolios greatly in recent years as mines had difficulty finding other financing and/or

needed to reduce their debt loads. They are low overhead operations & hence a disproportionate share of any future increase in the product price will flow through to their bottom lines

[11] State-Owned Enterprises.

[12] At last report 44% of London's residents were non-white, up from 29% in 2001.

[13] The supply of which has been compounded by the fact that, a partly El Niño-driven drought has reduced the "head" of water behind the country's main power generating dam, the world's fourth- largest, to a "near-catastrophe" level.