GLEANINGS II - 742
Thursday January 3rd, 2018

Note : I couldn't be bothered commenting on President Trump's January 2nd Tweets, even if they may have brought the world closer to a 'nuclear event', after he engaged in juvenile 14 year-old locker room talk, that his dong (Oh, excuse me, his button), is bigger than Kim Jong Un's, talk unfit for any adult male, never mind the President of the United States. If the US political class had any balls, it would now be moving post haste to impeach him (remember this is a **political**, not a **legal**, procedure that takes a simple majority in the House to lay the charge, & a 60% majority in the Senate to confirm it *which should be much easier now than even a few days, since the GOP now has a paper-thin majority in Senate & three Senators (as well as 25 members in the House) who in their 'lame duck' days may be inclined, if push came to shove, to vote for what they deemed best for their country & their party*. The most telling observation on this originated with Neera Tandem, biased as she may be as a strong Hillary supporter, who observed "Words cannot describe how humiliating it is to have this person as our president."

Quote of the week - "In the 20 years since we started the Eurasia Group, the global environment has had its ups and downs. But if we had to pick one year for an unexpected crisis - the geopolitical equivalent of the 2008 financial meltdown - it feels like 2018." *This is the conclusion of its January 2nd report on* <u>The Top Ten Risks for 2018</u> *that can be googled & lists them as 1. China loves a vacuum, 2. Accidents, 3. Global Tech Cold War, 4. Mexico, 5. US-Iran Relations, 6. The Erosion of Institutions, 7. Protectionism 2.0, 8. UK, 9. Identity politics in South Asia and 10. Africa's Security.*

Quote of the week No. 2 - "Trump has to grow beyond the base and ... has to make himself less hated among a group in the middle." - *Ari Fleischer, Bush 43's one-time press secretary*

Atlanta Fed's GDPNow tracker - Its latest (January 3rd) reading was 3.2% , up from 2.7% on December 27th but down from December 18's 3.3%, December 1's 3.5% & November 1's 4.5% - A major *downside risk for the GOP going into the midterm elections is a rate of GDP growth that falls far short of his 4% promise; in fact the IMF's forecast is 2.3% & those in the December 13th FOMC meeting were 2.5% in 2018 (same as 2017), 2.1% in 2019 & 2.0% in 2020.*

Canada's household debt to disposable income ratio - In 1990 it was 88%, in 2000 109%, in 2010 159% & at last report 173% (*about half as high again as the US rate, due to the fact that during the Great Recession, US households paid down debt while in Canada they continued to add to their debt load with a "full speed ahead, damn the torpedoes" attitude*; interestingly, for years Canadians have been telling yearend pollsters that one of their New Year resolutions was to reduce their debt load, only again & again to fail to 'walk the walk'. Much of this growth in household debt has been driven by house prices (*& by homeowners monetizing the equity in their homes?)* & is known to be of concern to the Bank of Canada (*especially since survey after survey show that many households would be hard-pressed to deal with even relatively modest increases in interest rates*), and prompted the OECD to express concern that high house prices & the associated debt levels remain a "substantial financial vulnerability for Canada". *And if Ottawa's tightening of mortgage eligibility criteria that took effect on January 1st is successful in taking some of the oomph out of the housing market, this may come at the expense of a slowdown in construction industry activity, and hence of the 2018 GDP growth rate.*

Iranian protests - They have been ongoing for a week. While said to be the worst since 2009, these are different; for while those were in protest against the re-election of President Ahmadinejad & concentrated in the capital Tehran, these are country-wide & about bread &

butter issues like high unemployment among young people[1], rising food prices & military spending abroad while subsidies of benefit to the hoi polloi were being cut. So they have little in common with the 2009 unrest & are more of a threat to the geriatric clerics who hold the reins of power And worse still for the clerics, the protests have spread into the country's Western oil-producing regions that are largely populated by non-Persian and/or Sunni-, ethnic minorities.

Packaging revolution in the developed world on the way? - Its recycling industry has long depended on China taking its excess recyclable-, & recycled-, waste off its hands; thus 87% of the EU's recycled plastic was exported-, & in 2016 the US exported 1.42MM tons[2]/US$495MM worth of scrap plastic-, to China. But last July Beijing ruled that, starting January 1st, 2018, it was banning the import of 24 categories of recyclable & solid waste, incl. *Class 3 to 7* plastic, textiles & mixed paper. While the official reason given was to "protect its environment and reduce ... pollution from managing these materials", China's domestic sources of supply of recyclables are exploding as its population becomes more urbanized, its average standard of living rises & online purchasing becomes more de rigueur (in 2016 alone it was up 26.2% YoY). One unintended consequence of this initiative will be that it will make Chinese-made consumer goods *marginally* less competitive in world markets; for over half of all world trade today moves by container. And the container shipping lines' biggest problem is a shortage of "backhauls" (thus on the Trans-Pacific routes there is only one (*low*-paying) East-bound container load for every 2.7 premium-priced West-bound one; and since the East-bound containers full of low-added value materials account for the lion's share of the East-bound backhaul container traffic, this ban means that the price charged for hauling containers West will have to go up. And while ideally this ban would prompt the West to come to grips with its recyclable material overuse by using the price mechanism, in the real world it will likely resort to more undesirable short-term fixes, incl. financially enticing other developing countries to take their rubbish, burn the stuff (not environmentally friendly) or bury it in landfills (all of which too will have a cost attached to it).

US Personal Savings Rate - in November it was 2.9%, down from 3.7% in the year -, & from 6.1% in the two year-, earlier periods & one-third of the 8.8% of November 2012, and the lowest it has been in that month since 2007 (when it had been 2.5% prior to the Great Recession. And in the last sixty years it has been below 2.9% only three times : in October 2001 & for three months during each of the summers of 2005 & 2007. This suggests the absence of massive pent-up demand such as would be needed to give the US economy a big boost in 2018 *- In Canada it went from 2% to 6% during the Great Recession, then fluctuated between 3% & 6% (in late 2016) & in the last year declined to a decade-long low 2.5%.*

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<u>WHY THE ELEPHANT IN THE ROOM IS THE FED'S MONETARY POLICY</u>
(FP, David Rosenberg)

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1 40.22% of Iran's 80+MM-strong population is aged 24 years or less (with 97% of those in the 15-24 age bracket literate, many of them university grads. And in its 'middle schools nine of its weekly 32 hours of instruction are devoted to math & science & another four to a foreign language.

2 I.e. 50 lbs per capita.

- The media hypes the US tax reform legislation as a significant boost to the economy in 2018. And there are cases when fiscal stimulus has stimulated the economy early in the cycle when there is pent-up demand ready to be unleashed (*but with this economic expansion now the third-longest in the post-WW II period, the US economy now is well past its 'early cycle' phase*). With the key to success in stimulating the economy being fiscal & monetary policies working in tandem rather than at cross purposes, fiscal stimulus can only be effective in bolstering the economy when accommodated by an expansionary monetary policy, whereas the aspects of the tax bill that seek to bolster demand[3] via higher fiscal deficits are likely to elicit more aggressive Fed tightening than otherwise might be the case, especially now that we will have the most inexperienced Fed in three decades & the FOMC rotation *among Regional Fed Presidents* that all but ensures a more hawkish bias in 2018 *(especially now that there is growing anecdotal evidence of wage pressures).*
- While there is little, if any, historical evidence that fiscal policy changes alone can trigger economic recoveries (or recessions), monetary policy has a far more powerful influence on the business-, & market-, cycles; for the Fed has, through its control over the monetary base, the power to affect liquidity growth and it is shifts in liquidity, not taxation or public spending, that have the greatest effect on markets & the economy. And the Fed is now poised to start unwinding its bloated balance sheet by US$420BN in 2018, & another US$600MM in 2019; so, whereas most expect the tax cuts to add US$140BN to economy-wide earnings in 2018, & US$80BN (i.e. 0.4%) in extra nominal GDP growth gains, these incremental gains to nominal GDP economy-wide profits have to be weighed against a US$420BN withdrawal of monetary support by the Fed's quantitative tightening. And even if the Fed were to raise rates only twice next year, that would still create a US$100BN drag on nominal GDP growth next year : at the margin the Fed's *proposed* tightening in 2018 will have more than 6x the impact on the economy than the fiscal loosening & 3x that on corporate profits. And the impact of the liquidity shrinkage on equity markets will be evidenced by shrinking P/E multiples that will offset whatever corporate earnings growth there may be, leaving the indices flat for the year, although peppered by greater volatility. So don't be distracted by focusing on the wrong thing : the elephant in the room will be the Fed's monetary-, & not *the politicians'* fiscal-, policy.

On September 8, 2008, the onset of the Great Recession, the Fed's balance sheet was US$926MM. Three months later, on December 2008, it had grown to US$2,255MM & another two years later to US$2,917MM, after which Janet Yellen ***really*** *stepped on the Quantitative Easing accelerator to the point where its balance sheet's size peaked at US$4,493BN on November 2014 after which it more or less flatlined until the present - After graduation from the UofT Rosenberg joined Merrill Lynch Canada as an economist & subsequently served for seven years as Merrill's Chief North American Economist in New York until he left in 2009 to become Chief Economist & Strategist at the Toronto-based money manager Glushkin Sheff (AUM at last report of $8.9BN), a move said to be driven by his desire to come back to Canada but likely also by the fact that being an economist on the BUY side of the market is less prostitutional than on the SELL side; for his new colleagues expected him to tell them what they* ***needed-****, rather than what their clients* ***wanted-****, to hear. As a result, his often insightful observations are now often even more worthwhile.*

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[3] But that may not be as effective as the 'inside the Beltway' denizens seem to believ since the lion's share of the tax cuts will benefit the "10%" who by their very nature have a low 'propensity to consume' (i.e. spend a lesser share of their incremental after-tax income on consumption than would their lower income brethern & sisters.

WHITE HOUSE AIDES ALREADY ANXIOUS ABOUT 2018
(Politico, Elianan Johnson et. al.)

- While Trump returned from Florida in an upbeat mood, relaxed & riding high on his tax bill success
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- , his aides are looking forward to the New Year with trepidation. They see a *major* brain drain in the making & a continuation, *if not worsening?*, of the White House inability to recruit suitable replacements (as Chief of Staff John Kelly who has let a number of people go & is expected to fire more, can attest to). And while the Ty Cobb-led White House legal team has assured Trump (*to put him in a better mood & make him easier to work with?*) that the Mueller investigation is 'being wrapped up', the staff is expecting to have to continue to work under its shadow for a great deal longer[4]. And having gone full-out to push through legislation & Executive Orders in his first year, they see little scope for getting much done in a contentious mid-term election year.
- With a diminished margin in the Senate (*& a growing number of GOP Senate stalwarts, the latest being Utah's 83-year-old Orrin Hatch, a 40-year Senate veteran, being in their final year & hence not amenable to pressure*), White House aides & Congressional Republicans say they have little hope of any meaningful legislation making it to the President's desk for signature before next *November 6th* mid-term elections. Behind the scenes, White House aides & Trump's outside advisers are engaged in a fierce debate over whether to appeal to his conservative base by tackling welfare reform first before proceeding with his infrastructure plan (*which would add further to the deficit?*) that would attract more Democrat & voter support. Still others urge striking a a deal on DACA (Deferred Action for Childhood Arrivals) with the Democrats before tackling the infrastructure issue (& delaying the welfare reform issue). According to Newt Gingrich (who has become less critical of Trump, now calling him "stunningly effective") "Infrastructure first ... I wouldn't touch entitlements in an election year", and, while House Speaker Paul Ryan is 'hot' on welfare reform, a view not shared by Senate Majority leader Mitch McConnell (they two & the President are expected to settle their differences in a meeting at Camp David later this month).

A real danger for the nation is that, unable to recruit qualified, seasoned people for service in the White House (& would anybody in his right mind accept an offer to do so?), there will be little choice, as New Gingrich has suggested, but to focus on having ambitious (but still wet-behind-the-ears?) younger people join the White House staff.

CASES COULD OPEN DOOR TO PUBLIC PENSION CUTS FOR CALIFORNIA WORKERS
(AP, Jonathan J. Cooper)

- For decades a sacrosanct rule in California has been that pension benefits promised to public sector workers can never be taken away. But now, cases before the State Supreme Court seek to change that & clear the way for cuts in the state's employees' pension benefits, with major implications for its cities, counties, schools, fire districts & other local bodies, all of whom face ballooning pension costs. This issue will face Gov.

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[4] Which will negatively affect the President's mood (making him that much harder to work for & that more irrational/provocative in his tweeting?).

Jerry Brown in his last year in office, in part as a result of his earlier successful legislative efforts to reform the state's pension systems.

- At issue is the "California Rule" that dates back to *a series of* court rulings since 1947 that enshrined the idea that workers enter a contract with their employer on their first day of work that entitles them to retirement benefits that can never be diminished; while this gives them the security that after a career in the public service their retirement will be safe & predictable, this ties lawmakers' hands in responding to (*unforeseen?*) exploding pension costs. Moreover, while it is widely accepted that retirement benefits linked to work already performed cannot be touched, the California Rule goes one step further by prohibiting changes to pension benefits related to work yet to be performed.
- Many US pension systems face major pressures from the generous benefits *granted by earlier politicians taking the road of least resistance by not standing up to public sector union demands, comfortable in the belief that when the chickens came home to roost, they would be long gone & the consequences of their giving in would be someone else' problem*, severe losses during the Great Recession & anemic investment earnings since, and retirees living longer[5]. And while California's two major *public sector* pension funds[6] have US$750+BN in assets, this is only two-thirds of what they need to meet their future pension payout obligations; so they will have to collect billions upon billions of additional dollars from *already hard-pressed* state & local governments *to meet their future pension obligations,* thereby putting more pressure on their future budgets.
- The pending cases stem from a Brown-backed 2012 pension reform law that sought to rein in costs & end practices viewed as abusive; thus one benefit eliminated was that of the right to buy up to five years of credit before retirement benefits were calculated (so that the pension of someone with 20 years service could be akin to that of someone who had worked for 25) & another of "pension spiking", the 'jacking up' of salaries in workers' final years of service to boost their pensions. And, in a brief filed last November, Brown argued that "for years, self-interested parties, overly generous promises, whose true costs were often shrouded by flawed actuarial analyses, and failures of public leadership had caused unsustainable public pension liabilities".

A ruling is expected before Brown leaves office on January 19th; and if he were to win, the consequences could be nation-wide; for many public (& private?) sector pension plans are also significantly underfunded, although not necessarily to the same extent as California (although in at least one case, that of Illinois, they well be far worse). On the other hand, higher interest rates could alleviate some of this underfunding; for they would raise the discount rate used to calculate the Present Value (PV) of the pension funds' future payout liabilities.

<u>TRADE DISPUTE OVER CANADIAN NEWSPRINT POISED TO SQUEEZE US NEWSPAPERS</u> (Bloomberg, Jen Skerritt)

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5 US life expectancies have gone for 69.77 years in 1960 to 78.74 in 2015 (& in Canada from 71.13 to 82.14 years) although they have begun to decline *marginally* in the past two years; while this may not seem like much, it means that, assuming a 65 year retirement age, the length of the pension payout period has almost tripled from the 1960 actuarial assumptions.

6 The California Public Employees Retirement Systsem & the State Teachers' Retirement System.

- Canada is the world's largest producer of newsprint & the US its biggest customer; in fact 75% of all newsprint consumed in the US by papers from the Wall Street Journal down to the smallest 'community' one is imported from Canada. But Longview, Wash.-based North Pacific Paper Co. (Norpac)[7] has filed a trade complaint that Canada subsidizes its producers & thus gives them an unfair advantage in preserving a dominant market position, and the Department of Commerce is scheduled to announce this month if it will impose 15-25% countervailing duties on imports of uncoated groundwood paper used in anything from newspaper printing to book publishing; so its price is now at a three year high, up 4.8% since October 3rd, when the US investigation began. In the likely event the Trump administration will go the countervailing duty route, Canadian newsprint producers will have little choice but to pass its cost on to their customers thereby augmenting the US newspaper industry's problems from 28 straight years of declining circulation, greater competition from the Internet, & an 80% drop in advertising revenue in the past 12 years, and especially those of the smaller, local community-focused papers whose paper costs are *much* higher than the 5% of their operating costs of large ones like the New York Times. So a group of over 1,100 local newspapers on December 4th sent a letter to Commerce Secretary Wilbur Ross saying the *entire* market was being 'upended' by just one company (*& in industry terms a relatively small one at that*) whose claim appeared driven by "the short-term investment strategies of the company's hedge fund owners", or as Seth Kursman, a spokesman for-, *& Vice President, Communications, Sustainability & Government Affairs of-, Montreal-based* Resolute Forest Products, the world's largest newsprint makers, put it "this is really egregious ...This is one company. The whole U.S. domestic industry is against them" while Norpac's David Richey argues that his company is "simply trying to level the playing field to stay competitive to help preserve rural manufacturing jobs in the U.S."

The demand for North American newsprint has declined by over two-thirds since 2000 & by 37% in the six years ended December 31st, 2014, as newspaper circulation declined & export demand was weak despite rising newspaper circulation in Asia.

<u>MISSION ACCOMPLISHED</u> (The Economist)

- On December 11th President Putin made a surprise visit to *his* Khmeimim air base in Syria from which his air force in 2015 launched its bombing campaign against the Syrian rebels that now has achieved his aims in the region : secure military bases in the Middle East, derail the West's attempts to isolate Assad & have him still President (albeit as the enfeebled one of a country in ruins), thereby frustrating the US-backed attempt at regime change. From Syria he flew to Egypt to promote a deal to build a US$21BN nuclear plant on its coast & discuss the use by Russian military jets of airstrips in that country; and that same day to Turkey to enable President Recep Tayyip Erdgan to *proudly* announce progress on a deal to purchase a Russian air defense system.
- Not long ago this would have been unthinkable : Turkey, a NATO member, purchasing Russian military hardware, & Egypt, a close US military ally, *& the recipient of multi-billions of military & other aid,* playing footsie with the Kremlin? But like many others in the region they are frustrated by the lack of American leadership & by Trump's limited interest in Syria. And Erdogan now accepts that Assad will remain in power & is furious

[7] Once a JV of Weyerhaeuser Co. & Nippon Paper Industries Co., it has since October 2016 been owned by One Rock Capital Partrners LLC that like many of its ilk is more interested in maximizing short-term profits than in generating long-term cash flow.

about the US support for the Kurdish fighters in Syria that have ties with *Kurdish* militants in his country; so he has pivoted to the new power in the region. And since Erdogan had publicly disagreed with President Trump's plans to move the US Embassy to Jerusalem, Putin also damned this decision, not since it mattered to him, but to tweak America's ear.

- While in Syria Putin announced the immediate start of troops withdrawal, something that will go over well at home during the months prior to his re-election (*but only to replace them with pseudo-private military companies whose casualties would not make the headlines back home)* And with the Russian economy still sputtering, he sees the Middle East as a marketing opportunity; for the Egyptian *& Turkish* deals are not stand-alones : state-owned Rosneft is investing over US$1BN in Iraqi Kurdistan and both Jordan & Syria have signed up with Russia to build (*nuclear?*) plants for them.

But despite these 'wins' he may yet fail in his ambition for Russia to become the region's superpower. Syria will need lots of financial help that he is in no position to render. He is playing both sides of the street, siding with Assad while courting Saudi Arabia, upsetting Netayahu by his support for the Iranian militias in Syria & his public criticism of Trump embassy move decision, and seeking to seduce Egypt out of the US fold (which neither he nor President Sossi can afford). And, last but not least, French President Emmanuel Macron has also thrown his hat in the regional power contest 'ring'.