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A PEEK AT THE WEEK THAT WAS - December 07, 2013

Editorial Note: This week's Peek will be an abbreviated issue due to our pending office relocation and upcoming travel schedule. As usual, please curb your smile and keep howls of delight to a respectable level.

History, despite its wrenching pain, cannot be unlived, however, if faced with courage, need not be lived again.
Maya Angelou (1928 -)

Today, 72 short years ago, a then very aggressive Japanese empire decided to take things into their own hands and bombed beautiful Pearl Harbor in Honolulu, thus sparking America's entry into World War II. The Japanese had already invaded and occupied much of China in a brutal and barborous campaign. After Pearl Harbor, they embarked on a pre-meditated sweep through South East Asia in a conquest bent on securing the raw materials that they desperatedly needed for their very survival. As we all know, this ended badly for the Japanese, but not before much horror and mayhem was inflicted by all the protagonists involved in the conflict.

History tells us that Japan recovered in a miracle of economic endeavor, the likes of which the world had never seen. They peaked in the late 1980s before descending into a very bad case of deflationary doldrums and now hold the dubious honor of seeing their sovereign debt top the magical quadrillion yen mark.

Meanwhile, their old enemy, China, has undergone an economic miracle of their own and have overtakend Japan as the world's second largest economy behind the USA. The Chinese have long and bitter memories of the Japanese invasion and occupation. And they are now building a formidable navy of their own.

What does all this mean? Ultimately, it could mean a lot and it's worth a peek this week...principally because the Chinese just laid claim to some uninhabited rocks, which the Japanese have long deemed theirs. Unfortunately, these rocks lie inconveniently just a short jet ride from China, Taiwan and Japan...and we all know how well those three have historically gotten along.

As for Mr. Market and the action at Club S&P 1800...1700...1800, it was a topsy turvy week. On Monday, Club S&P hit 1809...things are hopping. But then there was a first hint of hangover and by Wednesday, the 1800 neon sign was down as the index descended to 1781. But not to fear...by Friday, fabulous employment numbers from the Bureau of Labor Statistics / Bureau of Ginnied Up Statistics (BLS / BOGUS) had things humming along again nicely. We'll be keeping a close eye on these BLS numbers for any revisions, which we suspect there will be...and not upward. And we'll keep watching the volume of trading...or

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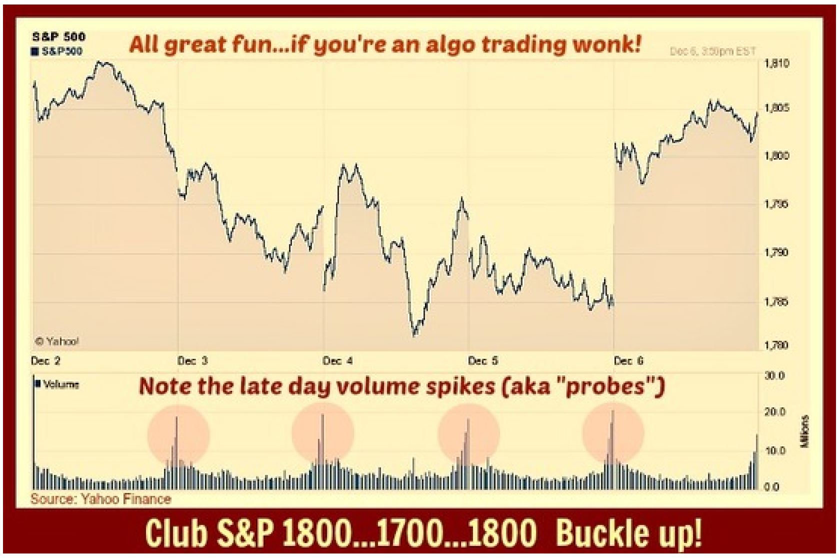
lack thereof, as well.

On the other hand, Ms. Bond was more deliberate. Her 10 year treasury (the one that matters a lot) started the week commanding a yield of 2.78% and ended the week up 10 basis points (one basis point = one one-hundredth of a percent) at 2.88%. So, within a week, the interest rate on this benchmark treasury moved over 3%. We'd keep an eye on this one too, if we were you. Especially as Bartender Ben and the gang now own approximately one-third of the US bond market. This is so eye-poppingly scary, we're going to make it our chart of the week.

Meanwhile, over at the Gold Bar, the action in the shiny stuff was almost as tupsy-turvy as the action in stocks at Club S&P. Gold per ounce started out at $1,246 before descending to around $1,212 in mid week before coming back to close on Friday at $1,230. There were the usual shenanigans from the usual suspects but with an estimated 90 paper claimants for every physical ounce of available gold, we wonder how long they can keep the lid on? They are probably wondering the same thing, especially as JPMorgan appears to have moved from seller to buyer in its own proprietary trading account.

Anyway, let's get started by taking a peek at the following charts show the action at Club S&P, the Gold Bar and Ms. Bond's 10 year US Treasury Note during the past 5 trading days. We are showing them to illustrate the topsy-turvy nature of things these days. We suggest that you get used to the turbulence and as we do in the cockpit, keep you seat belt fastened at all times during the flight.



The above chart shows a week in the life of Club S&P. It is a trader's paradise but all this noise can turn it into an investor's nightmare. Best to ignore the noise but be alert for the signals.

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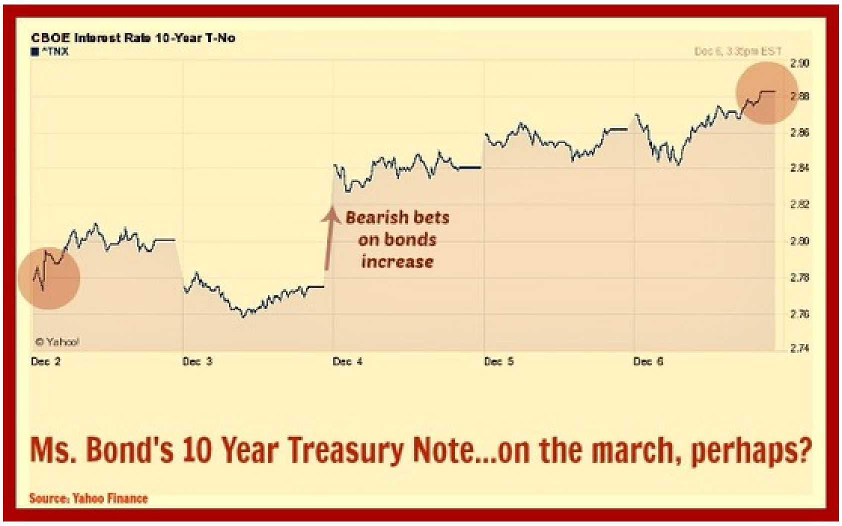
Topsy-turvy action at the Gold Bar too

This chart displays the action in the paper gold market last week. It shows the buying and selling in the Feburary futures contracts. This is noise too. But sometimes, if you are alert, you can use this noise to your benefit, as the paper sellers try to push down the price, creating oppportunities to pick up the real stuff at what might turn out to be truly bargain basement prices. Why would we say that?

Well...we suspect that one day there will be a wholesale dislocation between the real stuff and the paper stuff. It is already happening in places like India, where artificial suppression of supply (read import tariffs) has created a heated demand to the point where buyers are prepared to pay a serious premium (20%+) over the price quoted on the paper markets. You can read more on this here.

But what really caught our attention was a January report from the Reserve Bank of India (where obviously, gold is important) that estimated that the amount of gold traded in paper is more than 90 times the available real stuff. As we have said many times before (and will undoubtedly report on again), when the music ends, there will simply not be enough metal chairs for all those chubba-bubba traders. Perhaps it might be best to grab a seat now.



In the meantime, interest rates are not exactly standing still. While they may not be leaping, they are not creeping either. As the chart above shows, the benchmark 10 year treasury bond jumped 10 basis points (0.10%) from 2.78% to 2.88% last week.

While you might say...*"so what?"*...somebody else who bought that 10 year treasury bond when it was paying 2.78% might be saying something entirely different, which could include expletives. This is because if you are the owner of a bond...treasury or otherwise...interest rate increases are not good for you. Why? As we've explained before...the underlying value of your bond decreases as the prevailing interest rate for that bond increases, because if you had to sell it, the buyer would pay less to get the equivalent of the prevailing interest rate. Don't understand...just click here for a quick explanation.

Increasing interest rates are not good for borrowers either...whether they are Harry and Sally seeking a mortgage or Uncle Sam raising money to build a better drone. In fact, much of the world is so over-leveraged right now, that any substantive increase in interest rates could be fatal to the global economy. So let's move on quickly to Japan...the current poster child for being both over-leveraged and under-resourced.

Human consciousness arose but a minute before midnight on the geological clock. Yet we mayflies try to bend an ancient world to our purposes, ignorant perhaps of the messages buried in its long history. Let us hope that we are still in the early morning of our April day.

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- Stephen Jay Gould (1941 - 2002) -

The land of the sinking fund, also known as Japan, is facing some challenges. Its is literally deluged with debt, its demographics are diabolical and it is dependent on the world around it for the resources it needs to survive, let alone prosper. We seriously suggest that you take the time to view the very instructional video by clicking on the image below. It should be required viewing for all economics students but we doubt that it has ever been shown. It runs for a mere 7 minutes but it is do cleverly descriptive that even a central banker could understand it. In fact, they do. Which is why they are desperate to keep Ms. Bond at bay.

But, from the "why should we bother" department, let's go back to those pesky rocks languishing lazily in the East China Sea.

So...really...why should be bother? Well..firstly, they are known by three different titles, which is usually a sign of trouble. To the Japanese, they are called the Senkaku, the Chinese refer to them as the Diaoyu and to the Taiwanese, they are the Tiaoyutai Islands. From Wikipedia....with the emphasis ours, as usual:

> Aside from a 1945 to 1972 period of administration by the United States, the archipelago has been controlled by Japan since 1895. The People's Republic of China (PRC) disputed the proposed US handover of authority to Japan in 1971 and has asserted its claims to the islands since that time. Taiwan (Republic of China) also claims the islands. The territory is close to key shipping lanes and rich fishing grounds, and **there may be oil reserves in the area**.
>
> Japan argues that it surveyed the islands in the late 19th century and found them to be Terra nullius (Latin: land belonging to no one); subsequently, China acquiesced to Japanese sovereignty until the 1970s. The PRC and the ROC argue that documentary evidence prior to the First Sino-Japanese War indicates Chinese possession and that the territory is accordingly a Japanese seizure that should be returned as the rest of Imperial Japan's conquests were returned in 1945.
>
> Although the United States does not have an official position on the merits of the competing sovereignty claims, the islands are included within the Treaty of Mutual Cooperation and Security between the United States and Japan, meaning that **a defense of the islands by Japan would require the United States to come to Japan's aid**.
>
> In September 2012, the Japanese government purchased three of the disputed islands from their "private owner', **prompting large-scale protests in China**. As of early February 2013, the situation has been regarded as **"the most serious for Sino-Japanese relations in the post-war period in terms of the risk of militarised conflict."**
>
> **On November 23, 2013, the PRC set up the "East China Sea Air Defense Identification Zone" which includes the Senkaku Islands, and announced that it would require all aircraft entering the zone to file a flight plan and submit radio frequency or transponder information.**

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Hmmm....a few uninhabited islands. Strategically located. Full of fish and maybe oil and gas too. Relatively resource poor neighbors (both China and Japan are big oil and gas importers) with a history of bitter enmity; an assertive claim by the world's second largest economy against the world's third largest; who just happens to have an existing defense pact with the world's largest economic and military power...the good ol' U.S. of A.

What could possibly go wrong?

Politicians do crazy things when their back are to the wall or they risk losing their jobs..or their heads. Japan has obvious debt and demographic issues, which are increasingly coming to the fore. The Abe government is making noises about enhancing the Japanese military and nationalisim is on the rise. You can read more about this by clicking here and here.

Meanwhile, over in the Middle Kingdom, the Chinese have myriad issues of their own but are making great strides in modernizing their sizable military apparatus. But what is less recognized but is becoming more apparent is that China, in many ways, has their own potential credit bubble of gargantuan proportions...almost matching Japan's debt in terms of potential for destructive impact.

Chinese banking assets have, since the end of 2008, grown by 166% to an astronomical $24 trillion. This is an increase of $15 trillion in 5 years. That's a big number, far outpacing even the US...and we're no slackers in the money creation department. If fact, the Chinese banking system is now 2.5 times their GDP. And this does not include their massive shadow banking system whose size is anyone's guess.   Oh...and not to meniton that corporate debt in China is the highest in the world as well, at 150% of GDP. In other words, if that bubble pops, a lot of things could go awry quite quickly in the Middle Kingdom.

Against such a backdrop an ancient and very unpopular enemy could be quite convenient. The Chinese leadership have already mobilized their citizens in strident protests against the Japanese in the past over this same issue and now they have officially declared it a "fly over at your own risk" zone. The officially so-called East China Sea Air Defense Identification Zone has so far been ignored by the US, Japan and pretty much everyone else, including Gentle Joe Biden, who apparently told the Chinese to take a running jump. He probably said something entirely different, like how he told a dirty joke to a Seinfeld star, but that got lost in translation.

But why mix history and politics with economics? Why not? We are living in a seriously connected world. History leaves clues and our current economics are entirely dominated by politics. And you know how unifying a potential or actual conflict can be to a potentially restless populace. And while we deeply suspect that Mr. Market will once again become a manic depressive, we don't know what will set him off...so it's certainly worthwhile keeping an eye on potential flashpoints that might trigger a Mr. Market meltdown.

And while we all know that the Chinese are enormously patient, you never know what a desperate Japanese politician or a charged up Chinese jet pilot addicted to "Top Gun" replays and a slimmed down Kelly McGillis might do.

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CHART OF THE WEEK

The whole history of civilization is strewn with creeds and institutions which were invaluable at first, and deadly afterwards.

- Walter Bagehot(1826 - 1877) -

Our chart of the week below should deserve your close attention. We borrowed it from the ZeroHedge blog and we quote (with emphasis ours):

> *...it shows the Fed's total holdings of the entire bond market expressed in 10 Year equivalents...[and]* ***the amount of securities that the Fed can absorb without crushing the liquidity in the "deepest" bond market in the world is rapidly declining****, and specifically now that the Fed has refused to taper, it is absorbing over 0.3% of all Ten Year Equivalents, also known as "High Quality Collateral", from the private sector* ***every week****. The total number as per the most recent weekly update is now* ***a whopping 33.18%****, up from 32.85% the week before. Or, said otherwise,* ***the Fed now owns a third of the entire US bond market****.*

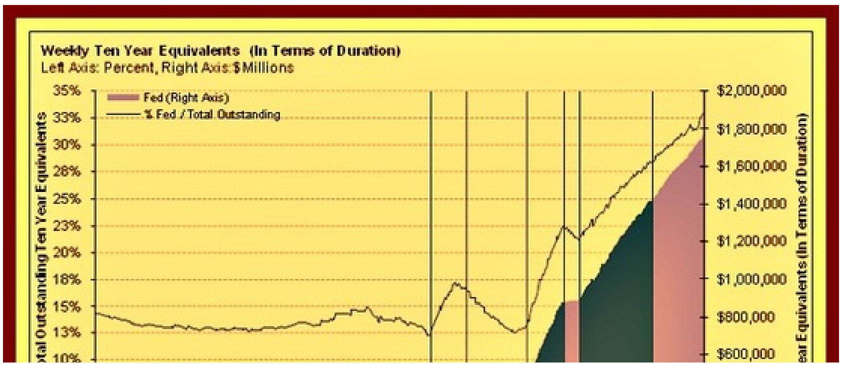
Ben and Janet are in a tough place. They know that if they stop printing and paying for the Treasury bonds issued by Uncle Sam to make ends meet, then other lenders, like our Ms. Bond, will likely demand higher interest rates. Higher interest rates, as we've learned, decrease the value of Ben's Federal Reserve balance sheet (higher rates = lower bond values) and will put more pressure on the government's ability to meet interest payments (as well as potentially putting the kybosh on the so-called real estate renaissance). Any or all of these could really depress Mr. Market.

Go on....watch that Japanese debt video again or for the first time (just click here). Really...it's worth the effort and it will explain a lot.

So...we suspect that Janet will not taper anytime soon and guess what...if she just keeps up Ben's current pouring pace, the **Fed will own almost half the bond market by the end of next year and all of it by 2018 or so.**

Wow...presumably we can go buy Japanese bonds then.

As the great Jack Nicholson might say..." *something's gotta give*".



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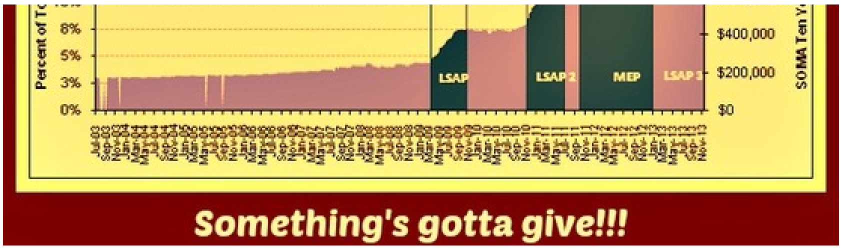

Til next week...

"Ignorance is the curse of God. Knowledge is the wing wherewith we fly to Heaven."
William Shakespeare

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