The mandate of JPM's London-based Chief Investment Office was to manage its asset/liability position (although it was said to have operated more like a hedge fund). But it was a huge profit generator (accounting in 2009 for 30+% of JPM's total profits) & in banking those operating them often acquire an aura of invincibility & are left alone without too many questions being asked *on the grounds that it doesn't pay to mess with a good thing*) ... until the wheels fall off at which point management denies all foreknowledge & responsibility, and jettisons a few fall guys. But in this case no one, not even JPM, is blaming a "rogue trader". What apparently happened is that, with the knowledge of, if not upon instructions from, senior management, the CIO made a huge bet in an obscure niche of the derivatives' market without fully taking into account the "thinness" of the market in that niche. When hedge funds discovered JPM's exposure, they started betting against it, pretty sure they had it by the short hairs, & now JPM's losses are their gains - *JPM has since reported the ritual creation of a sacrificial lamb to save the CEO's bacon in the form of Chief Investment Officer Ina Drew, a 30-year veteran. She will be replaced by 41 year-old, Matt Zames, JPM's Head of Fixed Income, who joined the bank in 2004 after stints at LTCM (that went TU in the late 90's), Morgan Stanley & Credit Suisse, who in March 2008 was a key player in JPM's acquisition on the cheap of Bear Stearns after it had imploded six months before Lehman, & who is sometimes mooted as Dimon's successor-in-waiting as CEO.*

With Jamie Dimon having led the banks' cum lobbyists' attack on any & all attempts to bring in more bank regulation & the 'Volcker Rule' (that would inhibit banks' gambling) & his credibility now all shot to hell, one outcome of his bank's self-inflicted wound is that all but the most die-hard & wilfully blind Republicans now favour more bank regulation, lobbyists be damned.

Rep. Kevin Brady (R.-Texas) is sponsoring a bill in the House, & Sen. Mike Lee (R.-Utah) a companion bill in the Senate, to reform the Fed. They want to remove the full employment part of its mandate & limit it to maintaining price stability (*at the very time France's new President, François Hollande, wants the ECB to move in the opposite direction, i.e. to ditch its price stability bias to concentrate on growth*). And they want to give the Presidents of **all** twelve Federal Reserve Districts a vote in the FOMC's monetary policy decisions (today only the Governors, the President of the New York Fed, & four of the Presidents of the other 11 Fed districts on a rotating basis have the vote). Their reason for wanting to give all Fed Presidents the vote is that they believe the present set-up overweights the influence of the Washington/ New York 'insider crowd' &, through the New York Fed President, of Wall Street (which pays his salary), and underweights that of the "country" Fed presidents, who are closer to conditions in those parts of the country where most Americans live & work *This is the latest instalment in the centuries-long antipathy to the "eastern establishment" in the peripheral parts of the US., which now, however, gaining more of basis in fact as the centre of gravity in the nation's population & economic activity continues to shift South & West from what Joel Carreau, at the time a Wall Street Journal editor, in his wonderfully prescient book <u>The Nine Nations of North America</u> thirty years ago called the <u>Foundry</u> nation, i.e. the declining industrial area stretching from New York to Chicago (the mindless pushback thereto, like King Canute seeking to hold back the waves, was demonstrated recently by the claim by a prominent Canadian federal politician based in Québec that Western Canada-produced oil pushing up the value of the Canadian dollar is costing manufacturing jobs in, & eroding the global competitive position of, Eastern Canada-based manufacturers' (& altering the 'natural political order of things' in Canada), a claim that a study made public this week by the Institute for Research on Public Policy found to be largely without foundation in fact).*

Messrs. Bray & Lee's reason for narrowing the focus of the Fed's mandate is that they believe that its full employment component part creates a bias in FOMC decision-making in favour of money creation even if this runs counter to the price stability part of its mandate (and, say the

Fed critics, the proof of the pudding is in the eating since all Bernanke's money creation doesn't seem to have done much for employment growth - *this question was supposedly settled thirty years ago in the Volcker Fed Chairmanship days when central banks concluded the two parts of their mandate were mutually inconsistent & decided to concentrate on price stability through 'inflation rate targeting'. But during the latter years of the Greenspan Fed Chairmanship, & with a vengeance under Bernanke with his 'super low interest rate strategy' that benefited banks but squeezed savers & ignored the age-old market adage that in monetary policy "you can't push on a string', price stabilitywas relegated to the status of being inconsequential.*

But there may be a slight problem on the way to the Forum for Messrs Brady & Lee. For, while the Fed Board of Governors is a federal agency, it is by statute independent. And the Fed itself is not government entity but a private company owned by, & operated on behalf of, its (bank) shareholders (as are the 12 regional Federal Reserve Banks) that has a franchise to print the nation's money & manage its monetary policy (although the US Treasury is entitled to all profits it generates after payment of a statutory 6% dividend to its/their shareholders).

A table in a market letter illustrated the recent growth in major central banks' balance sheets relative to their countries' GDPs. Since 2007 Japan's grew by one quarter from 23% to 29%, the ECB's doubled from 13% to 29%, and the Fed's & the Bank of England's tripled from 6% to 19% - *this illustrates the extent to which their governments' deficits have been funded by central bank 'fiat'-, rather than market 'real'-, money (which can't help but be inflationary).*

Last week UST yields declined for the 8th week in a row, the longest such 'streak' since 1998, as foreigners piled into them with great abandon. This caused one analyst to ask why the world would be rushing out of the Canadian-, Aussie- & Kiwi dollars since, if the US dollar is a safe haven currency (*with the US government possibly headed for a 'fiscal cliff'?)*, the other three are so in spades. Another analyst called the US dollar "the best-looking horse in the glue factory."

There has been a remarkable change, with major potential long-term implications for the US balance of payments, & Western Canada's & Canada's economy, in the deployment of the US oil & gas drilling rig 'fleet'. A couple of years ago 150 rigs were drilling for oil & 600 for gas, while in the First Quarter 2,000 were drilling for oil & 700 for gas (North Dakota's daily oil output has gone from 100,000 bbld in January 2006 to nearly 600,000 bbld today, has more than doubled in the past two years, & is continuing to ramp up at an accelerating pace.

The month of May has not been a happy one for gold bulls. The price of gold has cratered 7.2% since the beginning of the month, from US$1,660 to US$1,540, down one-fifth from its all-time high 8 ½ months ago. With the global economic & financial situation dodgier than ever, this seems counter-intuitive. One cause has been the strength of the US dollar as risk-averse money flees into the world's traditional "safe haven currency". Hedge funds have been selling assets on which they can show a profit to build up their cash reserves and/or free up cash for the Facebook IPO. The rapidly decline in its price has triggered margin calls for speculators. And in India, long the world's largest buyer of gold, the weak rupee has caused the local gold price to skyrocket, discouraging retail buying, while the government is doing its utmost to discourage its citizens from buying gold so as to minimize the deleterious impact of such purchases on its deteriorating current account balance. On the other hand, China has been importing gold at unprecedented 60+ tonne monthly rates & is not letting any of its domestically produced gold flow into commercial market channels (the combined effect of which is to remove the equivalent of 40% of newly-mined production from the supply chain (China is now the world's largest gold producer, even though it has only a few years' reserves). And the gold bulls had reason to cheer when, on May 17th, the manager of the US$500MM, 20,000 member

Okayama Metal & Mining pension fund announced he was allocating 1½% of its asset to bullion-backed ETFs to "escape sovereign risk". This is remarkable since gold yields no income & Japanese pension funds have been under growing pressure to generate more income as their beneficiaries age and/or retire; in fact, the fund's manager said the lack of income from gold had been a concern to his investment committee although he had been able to persuade them that "from a very long time point of view gold may be one of the safest currencies" (he also revealed he had sold Aussie dollars to raise the cash for his initial purchase) - *while his US$7.5MM is insignificant in the overall scheme of things, it nevertheless excited the gold bulls; for the Japanese pension fund market, with assets in the US$3.5TR range, is the second-largest in the world, 70% of which has traditionally been invested in JGBs despite their microscopic yields of recent years, with only a minute portion thereof, if any, earmarked for, & going into, 'alternate investments', incl. gold.*

The Greek equity market in November 2007 stood at 5,346. Now it is 580, down 89% & on May 14th the Greek government's 10-year benchmark bond was trading on a 27.67% yield basis. Meanwhile, Austria is proposing to "take advantage of the current low interest rates" by offering a 70-year bond (its 50-year bond is trading at 3.19%, 112 bps. over the benchmark 50-year Bund). And on May 16th it was rumoured that the ECB had ceased doing business with several Greek banks because they had negative equity (which wouldn't be surprising since in the past year nervous depositors have withdrawn an astounding 70BN Euros (30% of Greece's GDP) from Greek banks, an estimated 700MM Euros on Monday May 14th alone.

The latest EC data show Spain falling short of its latest 6.4% budget deficit target (which Madrid earlier had unilaterally revised from the 4.8% previously agreed to with the EU). While this supposedly would require further spending cuts, they are highly unlikely since Spain is already in the midst of its second recession in three years & youth unemployment is North of 50%. Meanwhile Madrid had to launch its fourth attempt to sort out its dysfunctional banking system amidst concerns that doing so could end up doubling its Debt/GDP ratio to over 150%.

Chancellor Merkel & President Hollande have not dissimilar middle class backgrounds. But there the similarity ends. She is a scientist with a Ph.D. in chemistry who has worked in the real world (albeit in a state-owned entity) & experienced first hand what collectivism can do to society. He, on the other hand, trained for, & worked all his life in, politics, idealizes a collectivist society run by a left-of-centre elite, has a Finance Minister who is the son of two of France's most notorious Communists & in his younger years was a member of the Communist Youth League himself, and knows nothing about business. In human relations, opposites sometimes attract & sometimes don't, and time will tell what will be the case on this critical occasion.

Hollande's Presidency was off to an ominous start. During the event immediately following his inauguration (which was a simple affair, whereas Sarkozy's in 2007 had been a 'coronation'), a parade up the Champs Elysée in an open convertible, the clouds opened & he got soaked to the skin. A few hours later this experience repeated itself during another outdoor event. Then, enroute to his critical, first face-to-face meeting with Chancellor Merkel, his plane was hit by lightning a few minutes after takeoff, causing it to have to return to base & making him one-and-a-half hours late for his meeting.

Elsewhere in Europe :

- one problem Chancellor Merkel faces is that, while German voters weren't happy in the 90's with having to pay for re-unification, at least that involved 'relatives', whereas in the

Eurozone crisis they look upon Southern Europeans not just as non-relatives but as people with whom they fought many wars over the centuries;

- as the economies of other Eurozone economies are going from bad to worse, the latest economic data from Germany were actually better than expected, & still in the black;
- while her Christian Democrat Party had its worst-ever performance in the elections in North Rhine Westphalia, Germany's most populous state, with a majority of its voters buying into the Social Democrats' 'more 'investment' in education & other "preventive" social programs that will 'save money later' program, nationally Chancellor Merkel's personal lead her Social Democrat counterpart remains at a solid 8% (although one possible fly in the ointment for her must be the growth in voter support in North Rhine Westphalia for her Free Democrat junior coalition partner);
- in Greece, the youthful (mid-30s) Alexis Tsipras, a former Athens City Councillor & now leader of the Coalition of the Radical Left (Syriza), was for strategic reasons decidedly unhelpful in the machinations to try & form a coalition government. In 2004 his party was created from several left-of-centre splinter groups & got six seats in the 300-seat Parliament. In 2007 its share of the popular vote rose by two-thirds & its seat total more than doubled to 13 (four of which it lost in 2010 when one of its component groups decamped). Earlier this month it broke the almost half century strangle hold on power of the right-of-centre New Democracy- & left-of-centre Pasok parties when, with 52 seats, it came in second to only New Democracy's 106 (up 17, albeit only after getting the 50 bonus seats the Constitution awards the first-placed party) & comfortably ahead of Pasok's 41 (down an embarrassing 119, with 50 of them accounted for by the winner's bonus after the last election). So Tsipras wants another election in the belief that candy always sells better than medicine, i.e. that his anti-austerity platform will carry the day in another election next month since most Greek voters still don't see the situation as so desperate as to make the price of medicine irrelevant, & are firmly convinced Europe cannot afford to take their country off life support (since if it does, the Huns will start pounding on Spain's door).

While the optimists maintain Tsipras is not **really** anti-Eurozone but just wants better bailout terms, this could become a case of 'an irresistible force (*of Greeks seeking to avoid more pain*) meeting an immovable object' (*of German dogmatism*). That is increasingly the common wisdom. But the latest poll, after the election was called for June 17th, gave Syriza 25.5% popular support (up from 16.8% in this month's election), New Democracy 21.0% (up from 18.9%) & PASOK 14.6% (up from 13.2%). This suggests two things. First, popular support is shifting from the fringe- to the main parties. And secondly, that even with the 50 seat bonus, Tsipras is unlikely to get an outright majority. But with 70+% of Greek voters wanting their country to stay in the Eurozone (*since deep down they trust non-Greek 'overlords' more than in their own politicians?*), he could be in a very strong position to deal with German intransigence since Ms. Merkel knows he is the only Greek politician with the cojones to call her bluff. And so far in Europe those who have called others' bluff have done OK. Tiny Iceland twice told the UK & the Netherlands to get stuffed & got away with it. And Ireland, at the time of its 2010 bailout, was faced with a France-inspired EU demand to raise its 12.5% corporate tax rate; but after telling the EU it was "non-negotiable", it still got its bailout & kept its 12.5% corporate tax rate.

And even if Greece were to leave, or were heaved out of, the Eurozone, its future might not look so bad. For then it would be able to devalue its currency & Europeans would flock to its shores to take advantage of 'budget holidays'. And if it defaulted on its debt, it wouldn't really matter what currency it was denominated in. As far as the rest of the world is concerned, the doomsayers who predict hell & damnation if that were to happen - the Washington-based IFI claims it will cost the global economy US$1TR & the German business magazine, Wirtschaft

Woche (Business Weekly) that it will cost European governments US$300BN (3% of Europe's GDP) at a time it can ill afford it, may be proven wrong, if only because the EU's foot-dragging over the last couple of years has given everyone ample time to position himself for such an eventuality. And Athens just bough everybody a little more time by paying back, on time & in full, 436MM Euros of bonds maturing on May 16th that hadn't been part of the recent restructuring (to the delight of some hedge funds that realized an annualized 135% return on their holdings).

In his May 17th press conference introducing his quarterly report on inflation *the outgoing* Bank of England Governor Mervyn King was his usual, for a central banker, outspoken self when he said that the Eurozone was "tearing itself apart without any obvious solution" & that the UK economy could not expect to escape unscathed. And Prime Minister David Cameron followed that up by saying "The Eurozone has to make a choice ... it has to take steps to secure its weaker members ... It either has to make up or it is looking at a potential breakup ... It is a choice they cannot long put off."

GLEANINGS VERSION II
No. 462 - May 17th, 2012

DOUBLE OR NOTHING : HOW WALL STREET IS DESTROYING ITSELF (Azionomics)

- Slate, Bloomberg & the Harvard Magazine all say that in the last two decades banking has moved away from an investment-led model to a gambling-led model (*& like pilots, there are bold gamblers & old gamblers, but few bold old gamblers*). This was first exemplified fifteen years ago by LTCM & most recently by MFGlobal blowing themselves out of the water by, as one wit put it, "picking up nickels in front of a steam roller". As Nassum Taleb demonstrated in his book Black Swan, betting huge amounts of money often for small gains each time (*to make big profits on an aggregate annual basis*), is a very 'fragile' strategy (*for the future doesn't always evolve as the computer models predict it will & it takes many small gains to offset the impact of a single large loss*).

Once banking involved economically & socially beneficial 'financial intermediation'. Commercial banking 'harvested' savings from small investors with more money than they needed to 'onlend' it, at a spread, to those who needed more money than they had to do things that made the economy grow. Investment banking did the same, only on a larger scale & for a fee rather than a spread. Stock markets once too played an economically & socially positive role, enabling entrepreneurs to raise money on a large scale for economy-growing endeavours, & providing an facilitating changes in the ownership of outstanding shares that enhanced the appeal of share ownership. Ditto for the early futures & derivatives markets : they let ***real*** *people to lay off* ***real*** *risks, for instance by enabling grain growers to 'fix' the selling price for the grain they hoped to harvest several months hence & millers to 'fix' their future input costs. Derivatives too, in their earliest form, interest rate swaps, were economically meritorious since they intermediated between banks that could borrow short-term money cheaply but had to pay up for long-term money & governments whose comparative funding advantage at the long end was greater than it was at the short end. But the rot started to set in & the tail to wag the dog, and the means became the end & the medium the message, when banks quit intermediating between* ***real*** *parties & hired Ph.Ds in Financial Mathematics to blue sky how to intermediate between '****virtual****' parties in ways that, as Goldman's CEO once conceded, likely generated few real economic benefits (but at the micro level were hugely profitable for the banks). Alan Greenspan was right when once he noted that risk cannot be made to disappear but that it helps to get it more widely distributed; but he failed to appreciate that in the process the risk is typically shifted from the balance sheet of the risk-astute to that of the risk-naïve, so that risk redistribution* *becomes what one of my friends in the financial community called “a daisy chain” (i.e. one that breaks easily) & another “taking in each other’s dirty laundry”.*

<u>U.S BANKING SYSTEM GETS STRONGER : BERNANKE</u> (Bloomberg, Craig Torres)

- On May 10th, in a speech at the Chicago Fed’s Annual Conference on Banks, he said that the US banking system is stronger & more resilient (*than whose? Greece’s?, Iceland’s? Afghanistan’s?*), while still facing challenges on credit quality & liquidity but that they “still have more to do to restore their health and adapt to the post-crisis regulatory and economic environment ... (*and that, as the economic expansion proceeds*) a financially stronger banking system is well-positioned to expand its lending.”

Rather ironically he made these remarks on the very day of the JPMorgan ‘thunderclap on a sunny day” *news that it had lost US$2BN in a matter of weeks. Obviously JPMorgan’s Jamie Dimon hadn’t given him a ‘heads-up’ & the Fed hadn’t been on top of the situation. It’s increasingly starting to look that, expert on the Great Depression or not, Bernanke may turn out to have been the worst Fed Chairman in its 95-year history.*

<u>BOEHNER LAYS DOWN MARKERS ON YEAREND ‘FISCAL CLIFF’</u>
(msnbc, Michael O’Brien)

- May 15th was the date for the Third Annual Fiscal Summit in Washington sponsored by the Peter G. Peterson Foundation. Ahead of it House Speaker John Boehner (R.- OH) said that the House will vote “before the election” on extending the Bush era tax cuts (that will otherwise expire on January 1st) so as to give lawmakers *in the New Year* a chance at broad-based tax reform that “lowers rates for individuals & businesses while closing deductions, credits and special carveouts.” During the Summit the House Budget Committee Chairman Paul Ryan (R.-WI) said “I don’t think you’ll see a permanent resolution to our problems in a lame duck session. I’m not sure that it’s the appropriate place to do so”, and Boehner that “I think in the lame duck session you’ll (*only?*) see something to make sure we don’t have a train wreck” & as to the need to raise the debt limit that “When the time comes, I will again insist on my simple principle of cuts and reforms greater than the debt limit increase” for *“This is the only avenue I see ... to force the elected leadership of this country to solve our structural fiscal imbalance.”*

During the Summit Secretary Geithner said that the debt ceiling likely won’t need to be raised until early in the New Year. And Boehner subsequently told NBCNews in response to a question as to whether he was threatening default “I am not threatening default ... what I am trying to do is to encourage people on both sides of the aisle on both sides of the Capitol and on both sides of Pennsylvania Ave to be honest with the American people and to be honest with ourselves to begin to tackle this problem in an adult manner” - most sensible people would agree with the sentiment he expresses, but unfortunately actions speak louder than words & his words belie his party’s ‘it’s our way or the highway’ approach to politics. The next day President Obama met with Congressional leaders at the White House &, while the official line was that the meeting had been “cordial”, Speaker Boehner apparently took offense at the President responding “Yes” to his question if he (i.e. Obama) was planning to ask Congress to raise the debt limit without corresponding spending cuts. And the Presidential Press Secretary, Jay Carney, told reporters during his daily press briefing “You have to ask the Speaker of the House whether or not he intends or believes it is the right thing to do for the American people or the American economy to play chicken with the full faith and credit of the United States of America.”

<u>MESSAGE TO ASSAD?</u> (NBCNews, F. Brinley Bruton)

- An exercise, Eager Lion 2012, involving 11,000 troops from 19 countries is underway in Jordan within miles of the Syrian border "to build functional capacity and enhance readiness." According to a source close to the Jordanian government, it is the first of its kind in 15 years "in terms of size and importance."

The countries involved, apart for the host country, include all the 'usual culprits' like the US, UK, France & Italy, and Saudi Arabia, Bahrain, Iraq, Kuwait & Qatar, but also 'outliers' like Brunei, Egypt, Lebanon, Pakistan, Romania & Ukraine, and among those that are notably absent are Germany & the Netherlands, the Nordic countries, Japan, & the Latin American & African countries

<u>UNEASY CALM PREVAILS IN TRIPOLI</u> (al-JAZEERA)

- After the authorities arrested Shadi el-Mawlawi, *a prominent local Salafist*, *on May 12th* violence broke out in the Northern Lebanese city of Tripoli that *by May 14th had* resulted in the death of nine people & dozens more being wounded, and the closing of one of the city's main squares.

The violence still hadn't ended on the 16th. Much has been made of the fact that Tripoli is is a Sunni Muslim city with a significant Alawite minority & that the two are at odds over events in Syria; for the latter support the regime of their co-religionist Bashar al-Assad while the former sympathize with their co-religionists in Syria who are the backbone of opposition to the regime. But this doesn't appear to be a much-feared spillover from Syria; for the Lebanese authorities arrested el-Mawlawi on evidence from European security agencies that he was engaged in terrorist activities outside Lebanon with possible al-Qaeda linkages. And the resultant days-long firefight was between the Lebanese Army on the one hand & Salafi Sunni activists on the other.