

Your weekly market update

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## Market Update

10 June 2016

**The number of Americans filing for unemployment benefits unexpectedly fell last week, pointing to sustained strength in the labor market despite a sharp slowdown in hiring last month.** Wholesale inventories recorded their biggest increase in 10 months in April, which is expected to boost second quarter economic growth even as sales at wholesalers rose for a second straight month. Data points to economic momentum building after a disastrous first quarter.

Initial claims for unemployment benefits declined 4,000 to a seasonally adjusted 264,000 for the week ended June 4, according to the American Labor Department. Corporations do not appear to be shedding labor. All expectations are that hiring activity to resume in the coming weeks and lead an overall rebound in net employment growth. The number of Americans still receiving benefits after an initial week of aid dropped in the week ending May 28 to the lowest level since October 2000. The insured unemployment rate fell one tenth of a percentage point to a record low of 1.5 percent. Unemployment claims report offered the latest sign that the labor market remains strong even though the economy added only 38,000 jobs in May, the smallest gain since September 2010. A separate report showed job openings hitting a nine-month high in April and layoffs falling to their lowest level since September 2014. The underlying trend to a tighter labor market remains strong. The issue for corporations with the labor market is hiring new employees that are suitable for available positions, which in itself will add further tightening of labor markets



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and put pressure on wages to rise.

The health of the labor market will likely determine the timing of the next Federal Reserve interest rate increase. Fed Chair Janet Yellen reiterated the Federal Reserve desire to raise rates, with no hint on timing. Before May's dismal jobs report Ms. Yellen had signaled rates would rise "in coming months" if economic data continued to suggest that growth was picking up in the second quarter. The Fed lifted its benchmark overnight interest rate in December for the first time in nearly a decade.

In a separate report, the Commerce Department said that wholesale inventories increased 0.6 percent in April after rising 0.2 percent in March. Economists polled by Reuters had forecast wholesale inventories nudging up by only 0.1 percent in April. Sales at wholesalers jumped 1.0 percent in April after advancing 0.6 percent in March. With sales increasing solidly for a second straight month, it would take wholesalers 1.35 months to clear shelves, down from 1.36 months in March. Inventories are a key component of gross domestic product changes. The component of wholesale inventories that goes into the calculation of GDP excluding automotive increased 0.8 percent in April. This would prompt economists to raise their second quarter GDP growth estimates, which are currently around a 2.5 percent annualized rate. The economy grew at a 0.8 percent pace in the first quarter.

Inventories have been a drag on GDP growth since the third quarter of 2015. Businesses accumulated record inventory in the first half of 2015, which outstripped demand. Though the pace of accumulation slowed, inventories remained high in the second half of 2015 and the first quarter of 2016.

To all my readers, my apologies for loading up the first part of my weekly update with hard data. However by digging deep into all the information flow do we see a robust complete view. The American economic machine is starting to chug along at a quickening pace.

Europe and the EU are a whole other affair. Brexit (British Exit) has gained full momentum and the fear of a nasty economic fall out in

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the old continent is very real. France is not ready to let Britain get away from the European Union scot-free. If the United Kingdom votes to leave on June 23, Paris will push to ensure that consequences are felt swiftly and severely to avoid emboldening anti-EU forces elsewhere in the union, senior EU diplomatic sources said. France's tough stance foreshadows major difficulties for London in the event of Brexit, as a core EU member tries to assert their influence in a reconfigured economic union and sway other countries against adopting an easygoing attitude toward Britain. Some of those countries, such as Germany, are more inclined to favor a softer approach. The French push is focused on convincing the remaining EU countries to unwind all treaties and agreements binding the U.K. to the bloc quickly, so the divorce is sealed by withdrawing subsidies, re-evaluating trade relationships sector by sector, denying British supervisory bodies EU recognition in areas like financial services, and establishing new immigration rules, to name just a few levers, the sources said.

"If we say you are outside the EU but can keep all of the advantages, access to the single market without any solidarity, it's a terrible message for the rest of the EU," said a senior EU diplomat who asked not to be named. "A painless Brexit is impossible, if we want to preserve the rest of the EU." The need to send a message is all the more pressing for the French political elite with the anti-EU National Front (a political movement in France) positioned to make a strong showing in the country's 2017 presidential election. France would not be acting out of spite, but out of need and self preservation. If the vote passes, it will be a nasty separation and will spin a fragile Europe into deep economic recession.

Oil prices are climbing higher this morning, following larger than expected draw downs in the US and disruptions to supply in Nigeria, where militant attacks have driven production in the country to a 20-year low. Brent crude is currently trading at \$52.70 a barrel, up 0.4%. It is the highest since early October. While oil inventories still remain at elevated levels continued supply disruptions in Nigeria, have sent output to a 20 year low and this is helping underpin prices. This will be the third successive weekly

draw in a row has also helped sustain the uptrend for oil prices which has been in place now for nearly five months. The weakening American dollar has done little in the way to stop the upward momentum behind higher oil prices. If draw downs and disruptions continue the price for oil will hold and encourage energy traders to push prices even higher. A key for North American energy prices is that oil rig counts have hit bottom further curbing the over supply. America's rotary rig count from Baker Hughes was up 4 at 408 for the week of June 3, 2016. It is 460 rigs (53.0%) lower than last year. Rig count is now 4 above the lowest level since Baker Hughes started counting rigs in 1949.

China knows that it has to close so called "zombie industries" down steel mills, coal mines and other industrial units that are producing much more of just about everything than the world needs, depressing prices and hurting businesses and workers everywhere. However the politburo has been reluctant to act for fear of throwing millions out of work and damaging Chinese banks that have lent money to what are essentially zombie businesses kept alive by government policies and uncontrolled lending.

This fear helps explain why Chinese officials pushed back when the Obama administration demanded during this week's America China Strategic and Economic Dialogue that Beijing reduces industrial capacity. American officials need to keep pressing the issue, not only because China is flooding global markets with steel, aluminum and other goods, but also because China is living a fantasy that will see lost decades in economic recovery. All this smacks of desperation and a fantastic fall from grace.

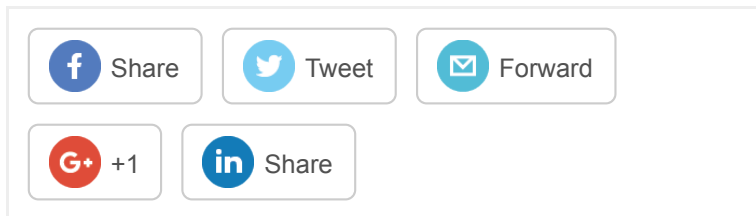
In 2008, China began pumping tens of billions of dollars into its economy and encouraged banks to embark on a lending spree to offset the effect of the financial crisis. As a result, the country continued to grow quickly, even as other countries slid into recession. The government intervention came at a high cost as businesses, many of them owned by provincial and local governments, borrowed excessively to invest in projects based on unrealistic assumptions about global demand. The result is that China now faces a debt problem and an overcapacity problem.

Goldman Sachs estimates that the amount of debt in the Chinese economy jumped to 235 percent of gross domestic product in 2015, from 130 percent in 2008. At its current trajectory, analysts say that number could rise to 344 percent of G.D.P. by 2020. Expect to see all of Asian and emerging economies tumble excluding Japan. Why not Japan? Over the last 30 years, China and emerging Asian economies have eroded Japan's manufacturing dominance bit by bit. Once again Japan is lean, economically rebalanced, low cost advanced manufacturing and hungry to export.

The Canadian dollar has been marching higher of late, and is now in sight of the 80 cent mark again helped along by generally stronger oil prices and lower expectations about and immediate interest rate hike by the American Federal Reserve. The appreciation of the Loonie should further rise with oil consolidating above \$50 a barrel. At above \$50 a barrel our Loonie is expected to see a straight line appreciation as oil prices rise putting governor of the Bank of Canada in a catch 22. Lowering interest rates in order to make our Loonie less attractive to investors and help Canadian manufacturing remain competitive globally would see an already wild real estate market in Canada just rage. By waiting to take cues from the American Federal Reserve, the Bank of Canada has put both our golden goose (housing sales) and a fragile but recovering manufacturing sector at risk. The Bank of Canada should have followed the lead of Australia which effectively raised interest rates while tightening lending and home ownership rules to cool the housing market and since lowered interest rates again aggressively to keep manufacturing and the Aussie dollar competitive. Home prices in Vancouver and Toronto are hitting unattainable levels as affordability becomes out of reach. Canadian banks are being asked to tighten their lending rules and limit million dollar mortgages unless higher down payments are provided.

Given a choice between growing manufacturing, a low competitive Loonie and risk an out right real estate market collapse, government policy will favor protecting our real estate market and ensure the right measures are taken to cool housing prices. It is

important to note that a dramatic rise in interest by our Bank of Canada of a mere 0.5% would translate into 17% in monthly mortgage payments. This is assuming the average mortgage interest rate is 3%. If however the average mortgage rate is 2.5% which I suspect it is closer to 2.5% than 3% since most individuals have had ample opportunity to refinance their debt at ultra low interest rates then it would translate into a 20% jump in monthly mortgage payments. The average household would not sustain such an increase, which would result in a pattern seen in 1994-1995 when interest rates jumped up wildly only to trigger powers of sales. The lingering effects of higher interest rates chilled real estate markets till 1999. Time for the Bank of Canada to stand up and take action.



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