



Richard Cluver Predicts

In our 27th year of service to the investing public of South Africa



Volume: 27

Issue: 37

07 November 2014

Economists everywhere are grappling with what for most of us is a new, or should I say previously unexperienced, phenomenon of deflation. So it is hardly surprising that most of my readers don't really understand the implications of it and its likely impact upon their investment portfolios.

So to briefly explain, a deflationary era is one in which the prices of most goods and commodities FALL. It is the opposite of monetary inflation. So, for example, we are currently witnessing the decline of oil prices which should presumably be good for everyone. I imagine we all felt a bit happier this month when we found we would be getting a bit more petrol for our rands? So how is that bad?

To understand why you need to understand the importance of the velocity of money movement. To explain this simply, a small quantity of money can achieve a lot if it is turned over rapidly. It can in fact equal a large sum of money that is inefficiently used. Thus, recognising that the holy grail of modern economics is the growth rate of the Gross Domestic Product, modern economies can be said to be in recession if for six months or more they have failed to achieve GDP growth. And, as I noted in this column last Friday, over the past 200 years the US has experienced a compound annual average GDP growth rate of 3.9 percent whereas for the past five years it has managed to only achieve 1.4 percent. Europe has been a whole lot worse and here in South Africa against an average growth rate of approximately 5 per cent in real terms between 2004 and 2007, the average fell to just more than 2 percent between 2008 to 2012.

It is because of this slow-down that everyone has been feeling the pinch. It is why unemployment is up and why everyone has been feeling a little gloomy. Worse, because of this general malaise we have been witness across the planet to a rise in hard-line politics which this week swept the Republican Party into control of both houses of US politics. In France Marine Le Pen's far right National Front party has caused a huge political upset by winning 25 percent of the vote while in Britain commentators are warning that Nigel Farage's UK Independence Party could win power at the next election. And here at home that "dangerous buffoon" Julius Malema has shocked everyone with the strength of support he achieved in this year's elections. Indeed, it was precisely the same situation that swept Adolf Hitler to power in Germany 80 years ago culminating in the most brutal war the world has ever seen.

For those who are a little mathematically inclined, a simple equation explains it all. Where V is the velocity of money, M the total amount of money and PQ is the gross domestic product, economists use the equation $V = PQ/M$. Translating that, there is an absolute relationship between the gross domestic product, the velocity of money and the total amount of money in circulation. And that being the case, the puzzle is that since 2007 the world's central banks have trebled the total amount of money that is in circulation but GDP growth has remained tepid.

Now, the Bank of Japan has embarked on a “whatever it takes” policy of printing further unimaginable sums of money and the European Central Bank has signalled the same intentions.

In any other era all this cash finding its way into the hands of the general public would have triggered an explosion of demand for goods and services which would in no time at all

have sent the prices of those same goods and services soaring. It would have resulted in hyperinflation: shades of the Weimar Republic experiment in the 1930s and more recently Zimbabwe’s reckless money printing exercise which in both cases resulted in ordinary folk needing wheel barrow loads of bank notes to buy a loaf of bread and, very soon, completely empty supermarket shelves. This time, however, the result has been deflation: falling prices as evidenced by the dramatic 35 percent fall in the price of crude oil over the past 30 months. And if you care to look at the prices of minerals like iron and platinum upon which this country depends for much of our foreign earnings, you will note the same phenomenon of massive decline.



Now you would have imagined that given this 35 percent crude oil price decline that the pump price of petrol would have similarly declined. But actually it rose. In March 2012 motorists at the coast paid R10.93 per litre. This month they are paying R12.75. So despite the crude decline we are now paying 17 percent more. Surprise surprise! Its all about taxation which is rising at a dramatic rate.

So lets bring that issue a little closer to home. Rick Crouch, the DA city councillor representing the ward that I like in, has written to residents to warn us that Durban Metro wants to borrow R1-billion to put up extra free houses before 2016 in order to win votes for the ANC ahead of the next election. The impact of that loan at current interest rates will put another 5 percent on the average Durban resident’s annual household rates, part of a series of cost burdens Rick Crouch estimates will overall boost Durban’s rate bill by a minimum of 20 percent next year. Rick is fighting the moves in council but, since the ANC dominates in Durban he does not expect to win. So his answer is to urge ratepayers to deluge the Minister of Finance, Nhlanhla Nene with letters of complaint. You can reach Minister Nene on <https://www.facebook.com/pages/Minister-Nhlanhla-Nene/585304381576040> or phone his personal assistant Mary Marumo on 012 315 5372.

The Durban housing project in fact neatly summarises what has been happening in government globally. Uncontrolled spending by politicians on a worldwide scale, the consequence of the loss of monetary discipline that resulted from the world’s move away from the gold standard a century ago, has resulted in an uncontrolled rise in the collective debt of governments nearly everywhere. That is why, for example, the combined debt of the US Government and its citizens has now exceeded 334 percent of US Gross National Product compared with 460% in the 17 economies of the euro-currency zone and 655% in Japan.

Funding this debt has placed an impossible burden upon the average citizen. With more and more being siphoned out of taxpayers’ pockets simply to service this towering debt, ordinary folk have less and less to spend on their personal needs and, since two thirds of GDP in most of the

developed world is attributable on average to retail spending, it is a no brainer that economic growth has slowed to a snail's pace. Worse, since most governments and many private individuals are funding debt repayments by raising more debt, the situation is becoming daily more untenable.

That is why the International Monetary Fund is worried that a series of economic collapses are probable bringing into question whether the global economic system can survive for much longer.

How do ordinary investors insure against the loss of their savings? Well let's start by noting that universally, blue chip shares have best survived global financial crises. Next note that the Rand is losing value relative to the US Dollar at an average of 12.6 percent a year so it is wisest to go for blue chips which hedge the rand: shares like Richemont, SAB Miller, MTN, Sasol and Naspers.

In addition, since there is a high probability of a Wall Street correction of the order of 15 percent over the next seven months, it is wise to hold some cash. I would advocate around 10 percent in cash right now.

Finally, as insurance against a global monetary crisis, I would advocate a 10 percent holding of Kruger Rands which are cheap right now but have over the past decade gained in value at an annual 11.5 percent.

The next month:

New York's SP500: I correctly predicted the end of the Indian Summer recovery and now I see shares sliding for at least a fortnight.

London's Footsie: I correctly predicted further recovery which I continue to see lasting for the next fortnight.

JSE Industrial Index: I correctly predicted fresh gains and I expect them to continue for another week.

Top40 Index: I correctly predicted declines this week but see a recovery beginning today and lasting another week.

The ShareFinder Blue Chip Index: I correctly predicted gains which I still see continuing until late-November.

The Rand: I correctly predicted weakness. Now I see a volatile recovery beginning Monday and lasting into early December.

Gold: I correctly predicted continuing declines which I foresee lasting until December.

Bonds: I correctly predicted weakness which I foresee lasting until November 18 before the next bout of recovery begins.

The Predicts accuracy rate on a running average basis over the past 523 weeks has been 82.64%. For the past 12 months it has been 89.1%.

Richard Cluver