



Richard Cluver Predicts

In our 26th year of service to the investing public of South Africa



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A comment by US correspondent Gary D. Halbert in our latest issue of *The Investor* offering arguments why the REAL US inflation rate is closer to 8 percent than the official 2 percent has been exercising my mind this week. If he is correct our JSE Blue Chips are massively UNDERPRICED when compared with Wall Street Blue Chips: a whole 234 percent cheaper!

According to Halbert the US authorities no longer adhere to the traditional view that the CPI should reflect changes in the cost of maintaining a constant standard of living. Instead, they argue that as prices rise consumers substitute cheaper alternatives, eating for example chicken rather than beef, and accordingly the real costs to the family are lower than would be the case when prices are measured in the traditional way. Stretching the argument further, the authorities note that average household income in the US has fallen to 92.7 percent of the average in 2000 and so, they say, families must be substituting cheaper commodities in order to get by. Underlying this trend towards manipulating the data, US President Obama is proposing to use this "chained CPI" method for calculating social security benefits.

If the US inflation rate, at least by the means that it is calculated in South Africa, is truly around 8 percent, that has potentially profound consequences for the prices of local bond and share prices. Consider the fact that today South Africa's R157 long bond is priced at a yield of 5.1 percent while an equivalent US long bond is priced at 1.9 percent. Investors seeking the security of placing their money in bonds obviously seek a "real" return on their money. To explain this, in South Africa inflation is eroding the value of money by an average rate of 5.7 percent and so the R157 is yielding a negative "real" return of -0.6 percent. US long bonds by the official CPI rate of 2 percent are yielding -0.1. So on paper it makes sense right now to invest in US long bonds where, in any event, there is far less risk if you believe the valuations of the international ratings agencies.

However, if the real rate of inflation in the US is 8 percent then the real return on a US long bond would more properly be minus -6.1 percent making South African bonds massively more attractive than their US equivalent. And since real bond yield comparisons set the value for all of a countries' investments, the implication is that our share market is similarly massively undervalued.

Note for example that the average dividend yield of the 30 shares used in calculating the Dow Jones Industrial Average is currently 2.82 percent while the average yield of the equivalent Blue Chips on the JSE is 2.9 percent, then to the normal observer South African shares are only very slightly cheaper than their US equivalent. However analysts today prefer using Total Returns when pricing shares. So, noting that the Dow has been rising at a compound annual average rate of 12.2 percent since March 2009, adding that figure to the average dividend yield of 2.82 percent implies that the "Total Return of Wall Street Blue Chips is 15.02 and that of JSE Blue Chips is 20.54 plus 2.9 which equals 23.44. Subtract the official inflation rates from those figures and we see that the real total return on the Dow is 15.02 minus 2 or 13.02 percent while the real total return on a JSE Blue Chip is currently 23.44 minus 5.7 or 17.74 which makes our local blue chips more attractive by an attractive 36 percent; which is why the JSE continues to attract overseas investors.

But what if the US inflation rate was actually 8 percent? Then the real total return on a US blue Chip would be just 7.02 percent compared with our real total return of 23.44 percent. That would imply that our Blue chips are worth a massive 234 percent more than their Wall Street equivalents.

I don't think that there is about to be a dramatic re-rating of South African shares. In my observation the fund managers who set the pace worldwide tend to slavishly follow official figures. But it is comforting to know that a growing band of overseas observers thinks there is something rotten in the US valuation system and that in time their view is increasingly likely to prevail.

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Strategy: Notwithstanding the above argument, local fund managers believe our market is ready for a downward correction in the not too distant future so I continue to warn readers to avoid speculative shares

The month ahead:

New York's SP500: The volatile upward trend that I predicted began a few days earlier than I expected and I now expect it to last a consequently shorter time very likely peaking today before trending downwards until around April 9.

London's Footsie: I correctly predicted the beginning of a market contraction which I continue to foresee lasting well into April. However a brief recovery lasting a week or so is now on the cards before the decline resumes.

JSE Industrial Index: The recovery phase I correctly predicted is likely to continue until April 12

Top40 Index: I correctly forecast weakness lasting until this week. Now I see a recovery lasting until April 17.

ShareFinder Blue Chip Index: I correctly predicted brief weakness which I see lasting until early April before a modest recovery is likely.

The Rand: I correctly predicted weakness until the end of March. Now I see a recovery beginning at the weekend and lasting well into April.

Gold: I wrongly predicted a brief recovery trend which has been delayed. But the overall trend for April is likely to be down.

Bonds: I correctly predicted further weakness followed by a very modest sideways to slightly strengthening phase which has now begun and should last until the end of April.

The Predicts accuracy rate on a running average basis over the past 471 weeks has been 81.62%.

Richard Cluver

Clients are advised that our alternative phone line on 031 764 7845 has been restored. Our principal line on 031 9400012 is partially working but voice is often distorted.