Our Weekly Paid Newsletter

Richard Cluver Predicts

In our 34th year of service to the investing public of South Africa

Volume: 34
Issue: 11

19 March 2021

This week, one of the biggest market stimulus package events of modern history began with US President Joe Biden's $1 400 "stimmy" cheques arriving in the post boxes of the 90-million Americans who earn less than $75 000 a year.

Given the experience of the Reddit Crowd's recent approach to the share market, it is thought that around a third of the $1.9-trillion package is likely to start impacting Wall Street over the next few days. Meanwhile, research by Oxford Economics, a UK-based consultancy, suggests that US households might have saved around $1.6-trillion (R24-trillion) during the pandemic, more than they would otherwise have done. Similarly, an HSBC study has shown that households in Europe and Britain probably saved €470bn (R8.3-trillion) and £170bn (R3.5-trillion), respectively, more in 2020 than they did in 2019.

While there are growing fears of a Covid "Third Wave" beginning which could put a damper on things, economists have begun speculating about the probability of a global boom igniting once immunization campaigns have delivered an end to the pandemic and everyone comes out to play. Their view is all that pent-up money will come like a torrent into the global economy just as it did a century ago after the Great Flu epidemic ended ushering in the "Roaring 20s."

As a result of all of these numbers, Fitch Ratings has upgraded its global growth forecast for 2021 to 6.1 percent. Meanwhile, US Federal Reserve Chairman Jerome Powell went further predicting growth of 6.5 percent for the US. He also made it clear this week that he intends holding US interest rates at their current, close to zero, rates for the foreseeable future…at least until 2023. In addition, the Fed will buy $120-billion of government bonds every month in future to further stimulate a probable blazing furnace.

This is precisely the pressure cooker situation I warned about in my latest Prospects newsletter. The last time this happened was when then Fed chairman Alan Greenspan kept rates artificially low, creating a housing bubble which led to the subprime market crisis of 2007. Bernanke piled on more to give us the present bubble and now Powell is re-doubling the issue.

Arguably, US debts were already too high to have allowed for interest rate increases by the time Bernanke was in charge for an increase then would likely have bankrupted the US; and that situation is now infinitely worse. Governments, companies and households raised $24-trillion last year to offset the pandemic's economic toll, bringing the global debt total to an all-time high of $281 trillion by the end of 2020 or, according to the Institute of International Finance, more than 355% of global GDP. The world has never before seen such debt and when it unravels the consequences for everyone will be horrendous.

So, though he and his team must be having sleepless nights for fear of the eventual consequences of this madness, Mr Powell arguably has absolutely no choice in the matter. But galloping inflation is now inevitable! As in South Africa where the Reserve Bank lending rate has been cut to its lowest level in half a century and a housing price boom has resulted, the same is true all over the Western World. Thus while US inflation as measured by CPI is officially 1.4 percent, conservative economists argue that this is deeply misleading. Most think it is probably closer to three percent while the US Case Shiller Home Price Index is up over 10 percent in the past year.

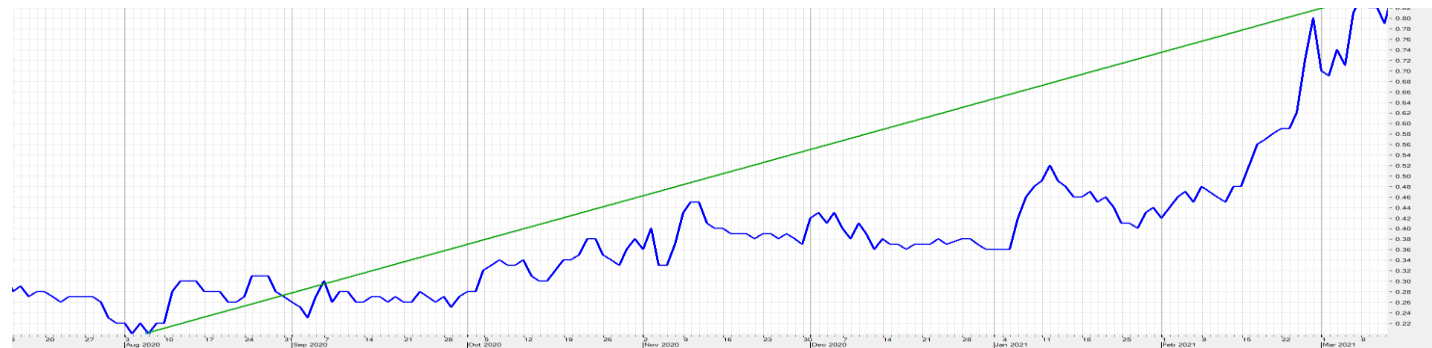
Of course, purists would argue that if the world were still on the gold standard one would easily be able to plot the real rate of US inflation by graphing the gold price and so, for you to consider, the purple trend line in the graph below suggests that over the past five years the dollar has been losing its buying power at compound 12.4 percent while, during 2020 it lost at an annualized rate of 26 percent as measured by the red trend line.

As an aside to this discussion, the same calculation for the SA Rand suggests, moreover, a long-term inflation rate of 14.5 percent and an eye-watering 37.3 percent for 2020.

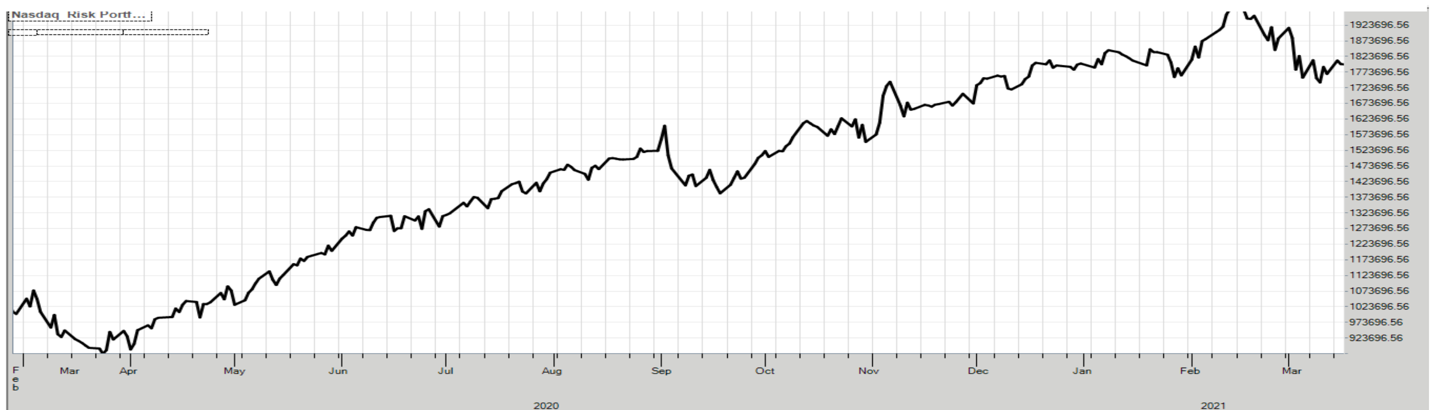
So, what does all of this mean for the ordinary investor? Well accepting that the world's major nations are now officially bankrupt: they are just living on borrowed time provided by one of the biggest monetary fraud's in history. It is, like the Steinhoff story, unlikely to end well.

We are about to start re-living Germany's Weimar Republic experience during which printing presses running 24/7 could not produce enough banknotes and desperate housewives took money by the wheel-barrow load to the grocery shop just to put bread on the table! Given South Africa's current unemployment rate, I quail at the social tensions that are about to be unleashed!

Given that US bond rates are now rising exponentially, it is clear that market professionals are well aware of the risks we are all now facing. Believe it or not, that green trend line on the US 5-Year T Bond yields is rising at compound 1 040 percent. That's what inflation does to bonds!



Expect share market prices to soar in the first phase. Note that the ShareFinder Risk portfolio graphed below which we began a little over a year ago with $1-million invested, touched a value of $1 973 700 in mid-February before easing back this week to $1 799 020. That, I need to point out, is the biggest increase I have ever seen in a long career of market-watching. It is a bubble that has to burst. The only question is when? When will the market first-timers wake up to what is happening and try to cash in before it is too late?



Shares like those in our Risk Portfolio are no longer being driven by the underlying profits of the companies they represent. Indeed, more than a few of them have never made a proper profit, let alone paid a dividend. So there is nothing to underpin them once the panic starts and history is likely to bury them.

Unfortunately, when the panic does start it will also take the Blue Chips with it and so everyone's portfolios will be decimated. But most of the Blue Chips will eventually rise again from the ashes because of their underlying quality. So if your holdings have underlying quality you could elect simply to sit it out.

So, my best advice to you is to hang in for now getting daily richer, but use this time to steadily take money off the table as the bubble expands. Make it an immediate priority to thus achieve enough in the bank to meet your living costs for the next year or two. And remember that if inflation goes where I fear it might, you will need a lot more cash than you usually budget for.

Then, once that is done, try to liquidate at least another 20 percent of your investment capital so you have a decent nest egg with which to pick up the bargains after the next crash. I know that our grossly immoral tax, Capital Gains Tax, is an impost that will prevent many of you from concerted action but it is better to pay the Receiver 20 or 40 percent and still have a goodly lump sum to start again once the dust settles than to be left with nothing!

Here in South Africa Government's borrowing costs are also rising strongly highlighting the need for it to live up to its promises of fiscal consolidation. Yields on the country's 10-year bonds have quietly increased by almost a percentage point from their 2021 lows reached in early February and are near their highest since October 2020. Based on the Bank's 3.5 percent repo rate, SA's inflation forecasts imply a negative real interest rate and so it's hard to see the country being able to sustain that rate for much longer as capital becomes scarce. So, although one must sympathise with students who cannot access the ANC's promised free education, Treasury clearly has its back to the wall and the situation is likely to quickly get very much worse.

Returning to investment strategy, it is my intention to, over the next **few months**, sell off all the Risk Portfolios which I report on in the Prospects newsletter. In the **Nasdaq portfolio** I will sell AAON at $83 or better, Adobe at $480, Align at $550, Cadence at $137, Idexx at $552, Lam Research at $612, Lululemon at $323, Market Taxes at $582 and Nvidia at $535.

In the **London Risk Portfolio** I will sell the Ashtead Group at £45, Antofagasta at £19, Halma at £25, LSE at £88, Renishaw at £63, Rentokil at £5.60 and Spirax at £133.

In the **Australian Risk Portfolio** I will sell Evolution at $5, Mineral Resources at $43, Northen Star at $12, Pro Medicus at $43, Seven Group at $23 and Xero at $143.

Do enjoy your weekend

The month ahead:

New York's SP500: I correctly forecast a recovery which I still see lasting until late May and then a decline to early August followed by another recovery until next January.

Nasdaq: I correctly predicted gains that I expect to continue until early June followed by a month-long correction and then further gains well into the year.

London's Footsie: I correctly predicted volatile gains which I still see until mid April and then a steep decline until mid-October.

Germany's Dax: I correctly predicted gains which I still see lasting until mid-April ahead of a decline until mid-June.

France's Cac 40: I correctly predicted the recovery would continue towards a peak in mid-April ahead of a long decline until late December.

Hong Kong's Hangsen: I correctly predicted declines until early April when a six-week recovery is likely ahead of a long slide down to mid-July.

Japan's Nikkei: I correctly predicted a new up-phase should last until mid-April before turning down until mid-June following which there should be gains until late October.

Australia's All Ordinaries: I correctly predicted a strong up-tick to mid-May and thereafter a fresh bear phase until mid-September... and my views remain unchanged.

JSE Top 40 Index: I correctly predicted the start of a long declining phase until July when I expect the market to bump along the bottom until late-August when quite a sharp recovery is possible.

ShareFinder JSE Blue Chip Index: I correctly predicted the beginning of a volatile decline which is likely to be over my mid-week followed by a recovery until mid-April when the next long decline should start and last until September.

Rand/Dollar: I correctly forecast gains. Now I see weakness until the first week of April followed by volatile gains until until the end of June.

Rand/Euro: I correctly forecast the beginning of a brief recovery which is now over. Now I see weakness until the end of the month followed by gains until the end of April when another short phase of weakness is likely. Overall, however, the trend will be in favour of steady gains until early September.

***The Predicts accuracy rate on a running average basis since January 2001 has been 86.09 percent. For the past 12 months it has been 93.04 percent*.**

US Fed to hold rates near zero to 2023

Bloomberg

Federal Reserve Chair Jerome Powell repeatedly stressed on Wednesday that the central bank won't raise interest rates until the U.S. economy shows tangible evidence it has fully healed from Covid-19.

In doing so, he discarded a cardinal tenet of monetary policy to pre-emptively strike against inflation. It's a significant shift that follows the Fed's new framework announced last year that markets have tested in recent weeks by pushing yields higher.

"He came out swinging," said Roberto Perli, a former Fed economist who is now a partner at Cornerstone Macro in Washington. The press conference "was an exercise in hammering through the same message over and over: we are committed to the new framework and what we are doing."

As a result, the Fed will wait for accumulating proof of "substantial further progress" on its employment and inflation goals before paring back its $120 billion in monthly bond purchases.

"Until we give a signal, you can assume we are not there yet," Powell said after the Fed held rates near zero and signaled they'd stay that way through 2023. "As we approach it, well in advance, we will give a signal that, yes, we're on a path to possibly achieve that, to consider tapering."

Ten-year Treasury yields rose to 1.687% earlier on Wednesday, the highest in more than a year, but ended the day slightly lower as investors absorbed the message.

Powell's challenge was to embrace the coming economic strength that will be delivered by massive fiscal aid from Washington, while assuring investors that "we're not going to act preemptively on forecasts."

"It was a clean break," from past Fed practice, said Lou Crandall, chief economist at Wrightson ICAP LLC. "They're willing to take the risk of being behind the curve. They don't think the risk is particularly severe and they don't think the costs of a miss on that side are as large as the costs of suppressing economic growth unnecessarily."

The Fed's forecasts showed unemployment dipping to a pre-pandemic levels of 3.5% by the end of 2023, with inflation nudging slightly above its 2% goal.

Officials raised their economic growth forecast to 6.5% for this year — which would be the fastest pace since 1983 measured fourth quarter over the same three months a year earlier — but then the impulse from pent-up demand and fiscal policy fades. Officials see growth advancing 3.3% in 2022 and 2.2% in 2023.

Powell dismissed the Fed's rate outlook — or dot plot — which showed seven of 18 officials predicted higher rates by the end of 2023 compared with five of 17 at the December gathering. He said the bulk of the committee expected rates to be near zero for the next three years. Prior to liftoff, they would also need to see "actual progress, not forecast progress — and that's a difference from our past approach."

U.S. central bankers conducted a broad internal review of monetary policy and announced their findings in August. They discovered that their previous focus on narrow indicators for employment and forecast-based policy leaned against more inclusive labor-market gains. Their new strategy seeks to average 2% inflation over time and they define maximum employment as a broad and inclusive objective.

The last rate-hike cycle began in December 2015. At the time, the unemployment rate for Black Americans was over 9% for November and inflation never reached 2% on a sustained basis in subsequent years, raising questions about whether the increase was premature.

In January, Fed Governor Lael Brainard said gains in employment "may have come sooner and been greater" if the new framework had been in place during the previous recovery.

Powell stressed that a global pandemic and a fiscal response of this size was not something forecasters have a lot of experience with calibrating, while both the labor market and inflation remain far from the Fed's goals.

"They are looking back to the pre-Covid period and viewing their forecasts as too optimistic," said Conrad DeQuadros, senior economic adviser at Brean Capital LLC. "They are saying, 'We don't want to make that mistake again."'

–With assistance from Steve Matthews and Rich Miller.

Everything Is Broken

By John Mauldin

I was on a client call earlier this week with Steve Blumenthal. The gentleman is at that stage in life where he needs cash income and not risk. Steve commented, "The bond market is broken."

And indeed, the traditional fixed income bond market is broken, thanks to the Fed.
We were able to suggest some alternatives (they are out there) that could help solve his problem.

But it got me to thinking... What else is broken? And the more I thought, the more I realized that the data that we use every day, the very systems that we are forced to work with, are indeed in various stages of being broken.

There is a great scene in the fabulous movie *The Princess Bride* where the criminal “mastermind” Vizzini keeps uttering the word “inconceivable.” After the nth time, Inigo Montoya turns to him and says, “You keep using that word. I don’t think it means what you think it means.”

Today we are going to look at data from the standpoint of Inigo Montoya. I don’t think that data means what you think it means. Indeed, much of the data in the way we use it is simply broken.

(In a few weeks, I will do a letter on things that aren’t broken, which are in fact incredible. I am an optimist, but I’m also realistic. I am “long” on the human experiment. Government? Not so much…)

Our economic and financial systems are badly broken in multiple ways. Some of the cracks are enormous, maybe beyond anyone’s ability to repair. ***Step one is admitting they are broken.***

Broken Credit

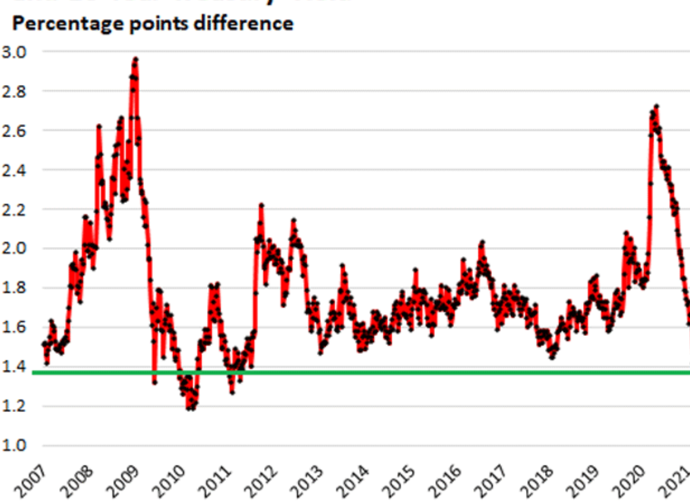
People correctly describe compound interest as a kind of miracle, even the “8th Wonder of the World.” The miracle has another side, though. For you to receive the benefit, someone else must go into debt or take risk.

Debt isn’t necessarily bad. It can be wonderfully productive if it lets you acquire something (like education) that increases your income, or a durable asset like a home. It becomes potentially problematic when used for other purposes, as is often now the case.

Excess debt accumulates in part because the price of debt (interest rates) is increasingly artificial. Politically-appointed central bankers manipulate interest rates and credit terms in order to achieve desired admirable policy outcomes, like higher employment and economic growth. Elected officials create subsidy programs that encourage yet more borrowing. And while they can point to a link between low rates and their targets, they ignore or forget about some of the unintended consequences.

These well-intentioned efforts may help some people, but they have side effects. Borrowing costs are widely mispriced, bearing little connection to the actual risk of a given loan. This is unfair to both borrowers and lenders. They pay/receive too much or too little. It is the inevitable result when committees, instead of markets, set important prices.

Here’s an example. This chart shows the spread between 10-year Treasury yields and 30-year mortgage rates.



Source: Wolf Richter

Obviously, lenders take more risk on mortgages than they do when buying Treasury bonds. We would thus expect mortgage rates to be higher, and they are. But does that risk really swing so wildly? Should it double, or fall by half, in only a few years’ time? Of course not. But that’s what happened, and there’s no mystery why. Mortgage spreads collapsed in 2009 and 2020 because the Federal Reserve bought truckloads of mortgage-backed securities.

Economic fundamentals didn't do this. A committee decided to encourage home purchases and did so by making it cheaper to finance those purchases. The predictable result is a housing boom. Or, in the current case, amplification of a boom that was already happening for demographic and other reasons.

This has benefits. The construction activity creates jobs. Lower mortgage payments leave people more cash to spend on other things. But it also obscures reality. No one really knows what their home is worth. The same for many other asset classes, and for the loans underlying them. We don't really have a bond "market" anymore. It broke long ago, and now we have a bond *regime* that exists outside the discipline of market forces.

I noted last week that the long-lost "bond vigilantes" are trying to rise from the dead. That is the way markets are supposed to work. I do not believe the Federal Reserve or other central banks will let them take control of the bond markets.

Peter Boockvar writes about what the Bank of Japan did:

> BoJ Governor Kuroda doesn't want any part of a further rise in yields and quashed any thoughts that he would widen the YCC range from the current level of 20 basis points from zero. He said, "Personally I believe it's neither necessary nor appropriate to expand the band. There's no change in the importance of keeping the yield curve stable at a lower level." Yields fell sharply in response with the 10-year down by 3.6 bps to just under 10 bps. It was 16 bps one week ago. The 40-year yield was down by 4 bps to .72% vs .82% one week ago. Again I'll say, they want higher inflation but then panic when rates go up. What they are now finally learning is the danger of what they wish for.

The same thing is happening in Europe and elsewhere. I firmly believe that at some point the Federal Reserve will begin to buy large quantities of longer-dated securities, taking interest rates down and driving a stake into the heart of those who want higher returns for the risks they are taking. That point is likely when the market drops (say) 20%. Until then they just let things rock along. The Federal Reserve is going to give us ***return-free risk.***

Broken Retirement

I could call this section "Broken Dreams." Millions of Baby Boomers are approaching what they thought would be a comfortable retirement age and instead finding they're nowhere near ready. Worse, many *believe* themselves ready when in fact they aren't. They will realize it only when markets show them what reality looks like.

The many reasons for this mostly trace back to the above-mentioned broken bond market. Retirement investing used to be easy. Save money, park it in interest-bearing instruments, and live off the income, with Social Security and maybe a job pension to help. Not complicated and it worked well for decades.

But about the time the oldest Boomers began reaching their mid-60s, this thing called "interest" mostly disappeared as committees and politicians decided to favor borrowers by keeping rates ultra-low. And just like that, retirement broke. The old method stopped working.

This left retirees and pre-retirees little choice but to "stretch for yield" in riskier assets. Indeed, that was the plan. The Federal Reserve under Bernanke, Yellen, and now Powell explicitly *wants* investors to take more risk. It's the other side of their desire to encourage borrowing. This is also called "financial repression."

So now we have retirees with far too much in stocks, junk bonds, or other risk-heavy assets. And not just individuals; the same is true for large pension funds. Their trustees are truly trapped: contractually obligated to pay certain benefits and unable to do so without robbing future beneficiaries.

I suspect my readers are more retirement-ready than most, but I still hear horror stories: people who worked hard, did their homework, made good decisions, only to see it all collapse. If you think you're prepared, or already retired and think yourself secure, I suggest you reexamine your assumptions. Retirement is broken and your dreams could become nightmares.

Broken Stocks

What happens when you force investors into an asset class they don't especially want or understand? Well, price comes from supply and demand. Artificially generated demand leads to artificially higher prices, and that is what we see in the stock market today. A survey in the year 2000 shows that investors expected future returns from the stock market would be 15% per year. I think current investors have similar expectations. They think stocks only go up, because the Fed will intervene if they don't.

I reviewed stock valuations in more detail a few weeks ago (see here) and everything I said then still applies. Anyone who owns passive index funds will endure a major drawdown at some point. I can't say exactly when but it's going to hurt. And who holds those funds? Investors who don't really want to be in stocks in the first place and/or don't understand the risks, or institutions that have little choice. Both categories are being forced by circumstances to make decisions they wouldn't make in an otherwise "normal" market.

At the same time, managers of many listed companies aren't making the greatest decisions, either. Many are responding to short-term incentives that encourage them to load up on debt, boost their share prices via buybacks, and profit by suppressing competition instead of innovating.

This is a stock market in which, much like bonds, prices bear little resemblance to fundamental reality. But more broadly, the equity markets are broken. I am all for making them accessible to everyone. Unfortunately, the regulatory and educational structure hasn't kept up. So what we've really done is empower people to do risky things without preparing them for the consequences. It's not going to end well.

Broken Data

Computer programmers used to talk about GIGO—Garbage In, Garbage Out. All the processing power in the world doesn't help if it only processes flawed data. That explains some of our economic problems, too.

Just one example, although an important one, is the monthly US unemployment rate. According to the BLS it was 6.3% in January and, as we learned Friday morning, officially fell to 6.2% in February. 379,000 jobs were added, with 355,000 of them being in leisure and hospitality, as hotels and restaurants open back up. We are going to see a lot of large numbers like this in the coming months, which is a good thing.

However, no one I know thinks the unemployment number reflects reality. Even Jerome Powell believes it is deeply understated. He said so in a speech last month, which my friend Mish Shedlock quoted recently. Here's Powell on February 10.

> After rising to 14.8 percent in April of last year, the published unemployment rate has fallen relatively swiftly, reaching 6.3 percent in January. But published unemployment rates during COVID have dramatically understated the deterioration in the labor market. Most importantly, the pandemic has led to the largest 12-month decline in labor force participation since at least 1948. Fear of the virus and the disappearance of employment opportunities in the sectors most affected by it, such as restaurants, hotels, and entertainment venues, have led many to withdraw from the workforce. At the same time, virtual schooling has forced many parents to leave the work force to provide all-day care for their children. *All told, nearly 5 million people say the pandemic prevented them from looking for work in January. In addition, the Bureau of Labor Statistics reports that many unemployed individuals have been misclassified as employed.* ***Correcting this misclassification and counting those who have left the labor force since last February as unemployed would boost the unemployment rate to close to 10 percent in January.***

You count as "unemployed" if you actively look for work. Powell says, I think correctly, millions *want* to work but for various reasons haven't been looking. So, they don't count and the unemployment rate is artificially low.

This leads to more perversity. Imagine (as we all hope) vaccination progress brings the virus under control, hopefully soon. The economy should begin recovering as consumers gain confidence. Among those gaining confidence will be some of the millions presently out of the labor force. Once they start actively looking, the unemployment rate may well *rise* even though the economy is improving.

In other words, the unemployment rate is effectively useless, at least today, as an indicator of labor market conditions or economic growth. Yet we all keep breathlessly waiting for it every month. This is broken. We need better data so policymakers can make better decisions.

Broken Unemployment System

Economists and statisticians have known that something as seemingly simple as unemployment claims is filled with errors. My friend David Kotok (of Cumberland Advisors) wrote about an email exchange he had with our friend Philippa Dunne (of The Liscio Report), highlighting these problems. Some random quotes:

> …Fraud that is understood to be happening ranges from lows of less than 4% of claims for some states up to an astounding 35% for the State of Michigan, which has had, historically speaking, a screening problem as much as a fraud problem.
>
> …Philippa wrote to me, "So, I guess that's what happens when you have a totally outdated system prone to failure. Legitimate people have a tough time, but organized crime has a field day."
>
> …Confirmed unemployment fraud in California now exceeds 11 billion claims, but there are more claims under review, so the actual figure may be considerably higher: "In addition to the 10% of benefits confirmed to involve fraud, the state is investigating another 17% of benefits involving suspicious claims that have not yet been proven to be fraudulent—about $19 billion worth."

David went on for several pages in his usual highly meticulous way providing dozens of links to the numerous problems in the unemployment claims world. Much of it appears to be organized identity theft that originates overseas. Elsewhere I read that there is the potential for $60 billion in total fraud.

You should be outraged for two reasons. First, any amount of fraud is unacceptable, much less this staggering amount. Second, as states try to deal with the fraud, they are less able to help legitimately unemployed people get the help they need and deserve.

True story: Let's just say my mind works differently than many people's. I read a simple report and a question gets triggered. It may have nothing to do with what I'm reading. But I go to Google and search. Six or seven years ago something triggered my curiosity about wigs (I have no idea what it was) and how much they cost. Google led me to Amazon and two or three websites. Within a minute I satisfied my curiosity and went on. For the next three months, every webpage I went to had an ad for wigs.

You have probably had the same experience with a different topic. In a world where Google, Facebook, Amazon, and hundreds of others can track your random searches, where we have blockchains and artificial intelligence, it is no longer acceptable to have fraud in the unemployment claims process. The system is broken.

I could go on describing broken things for many more pages. I had a whole section on Broken Inflation, which affects everything but is completely wrong because of the way we measure housing prices. I decided that topic needs a fuller explanation so we'll come back to it in another letter, maybe even next week. I also want to talk about the absurd way we measure inflation in the healthcare markets.

Add that miscalculation in and we might be at 4% inflation *right now*. Today. And the Fed wants to keep interest rates low. Because…?

The markets react to inflation numbers, unemployment numbers, and so on. But the numbers are broken. This will not end well.

All that said, I have to disagree with Bob Dylan. *Everything* isn't broken, and there are ways to handle these challenges and maybe even benefit from them. More on that later. But enough is broken to cause real problems. Many of them are avoidable if the right people would make the right choices. I hope they start soon.