The Investor©
In our 30th year of service to the South African Investing Public!

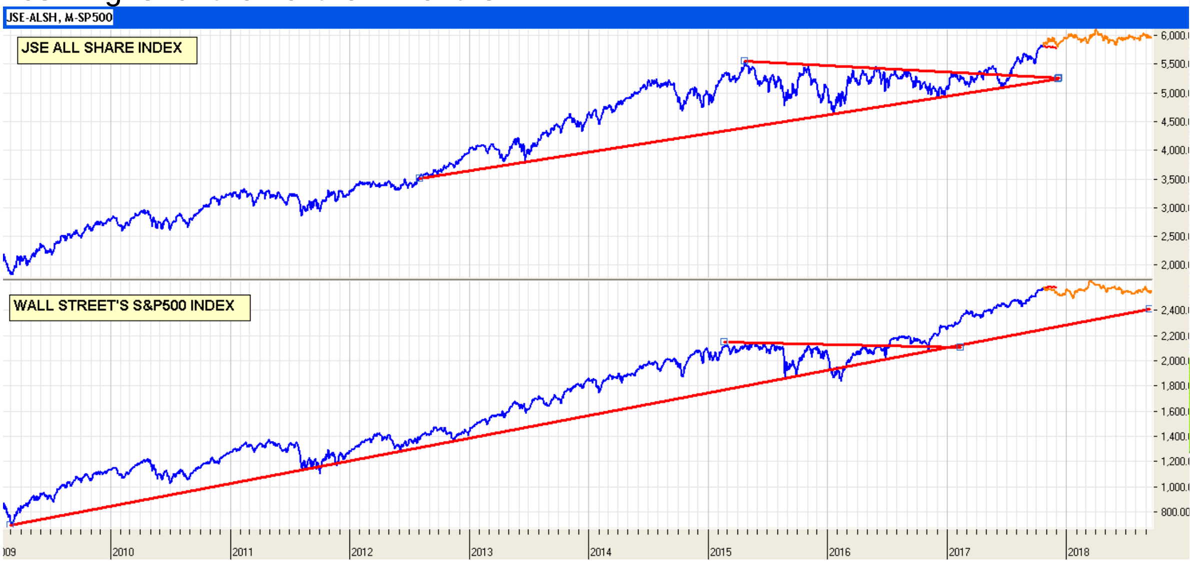
Onward and upward

By Richard Cluver

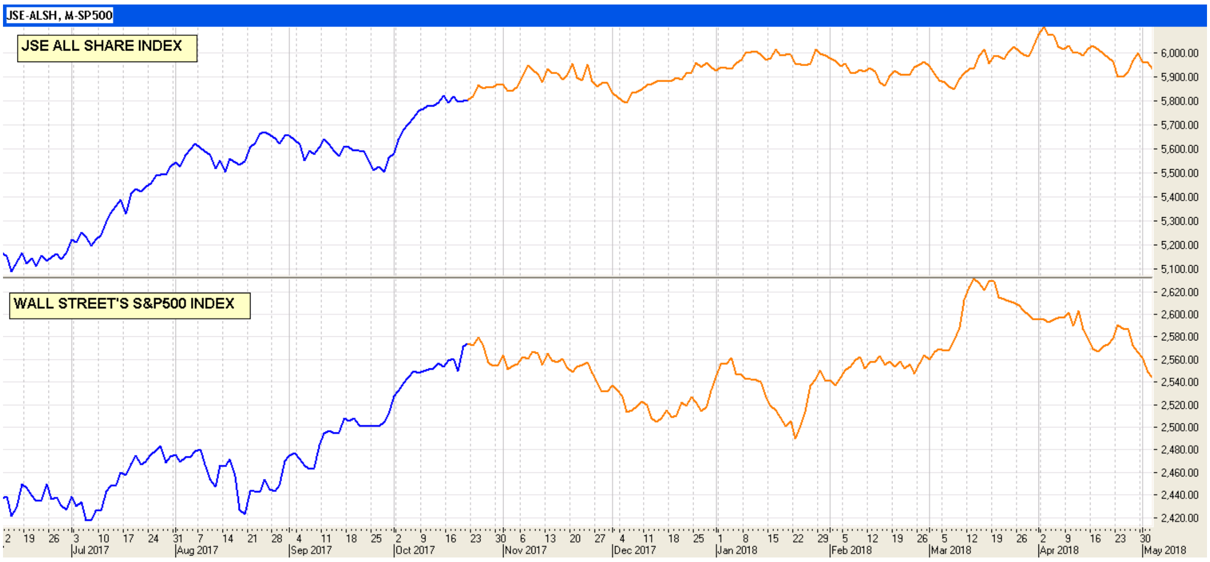
On Wall Street, the world's longest-running share bull market continues its unabated climb which, notwithstanding our own Zuma-led economic malaise, has lifted our own share market out of a two-year-long decline to take it to its highest-ever level.

So where to now? My graph composite below tracks the two markets since the end of the 2007 to 2009 "Sub-Prime Crisis bear market which has seen Wall Street in non-stop climb for the past eight and a half years. And ShareFinder's artificial intelligence system senses that both Wall Street and our own JSE are now likely to continue rising until mid-March and early April respectively as can be seen in the orange traces at the extreme right of each graph.

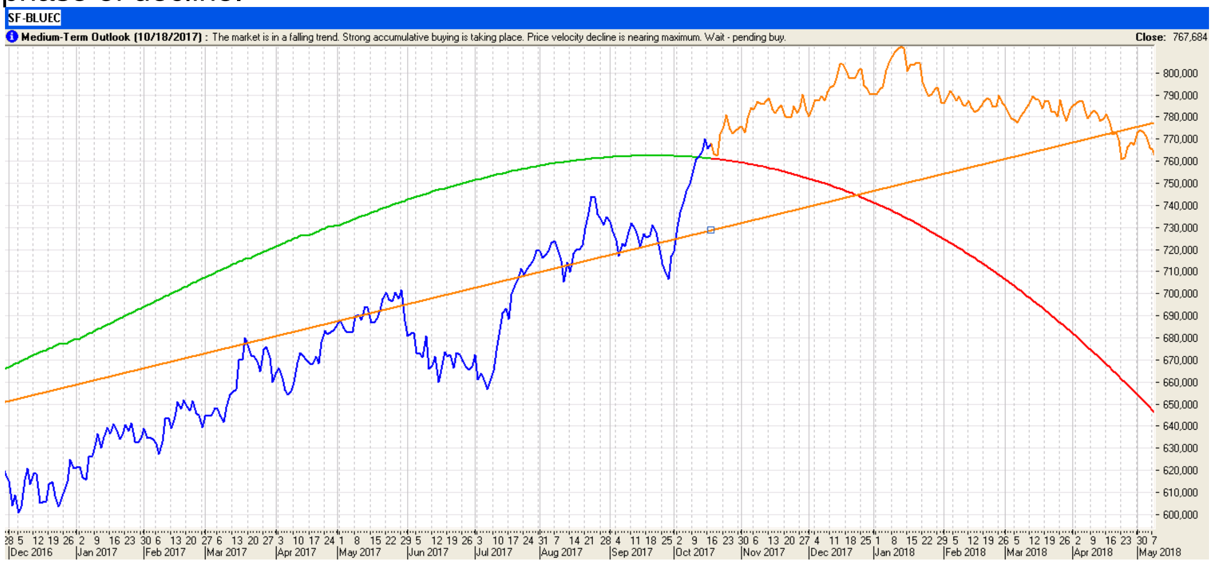
Our own market has, moreover, broken upwards out of a 30-month period of declining tops and rising bottoms delineated by a classic pennant formation which I have drawn onto the topmost graph below and which implies the probability of fresh highs for the next few months.



In the graph below I have blown up ShareFinder's predictions for the two markets in the months ahead noting that my software considers April 3 in the new year the likely end to the current bull market for the JSE preceded by a March 14 Wall Street top.



Blue chip shares, however, are likely to enjoy a shorter phase of glory with ShareFinder projecting that they will peak in value on January 12 followed by a long phase of decline.



Were the projected ending of the share market bull market to be accompanied by a global economic crisis, however, one would expect to see gold bullion soaring since this has always been the case in the past. However, ShareFinder does not see much future for Gold in the foreseeable future. In my next graph the dollar price of the metal appears likely to decline steadily throughout 2018.

But the Rand takes strain

By Richard Cluver

Lest you have failed to notice, the Rand has of late been losing ground at a significant rate against the British Pound and, while ShareFinder sees this as a medium-term aberration, it is having a significant effect upon readers' foreign investment values.

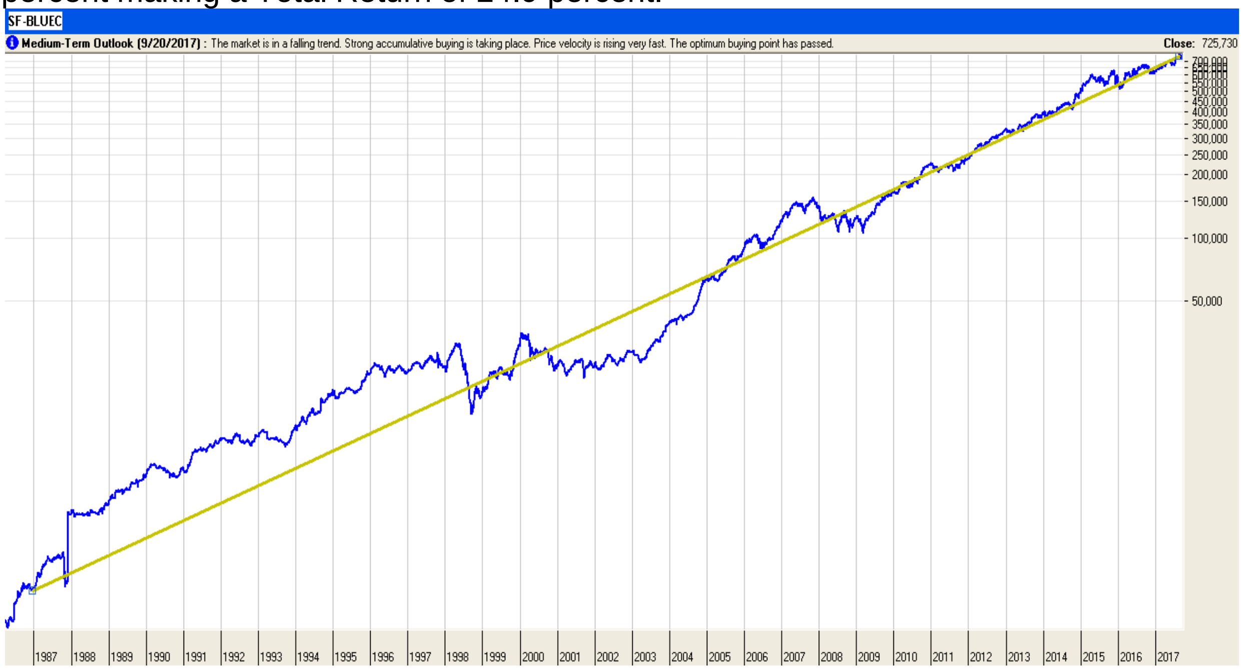
In my graph below, the yellow line represents the 30-year relationship of the Rand to the Pound back to the balmy days of 1987 when it took just R3.16 to buy a Pound. Compare that with January 19 last year when, in the aftermath of the axing of Finance Minister Nhlanhla Nene the Rand collapsed to R24.0117 to the Pound before beginning a long recovery which reached its apex on March 30 this year when it had reached R15.9578 to the Pound ahead of Pravin Gordhan's axing as Minister of Finance.

So let us note the yellow trend line on the graph which shows that had you bought British Pounds and simply put them under your mattress these past 30 years you would have earned 5.8 percent compound on your money throughout that period. However, if you compare that with the 8.8 percent that you can currently earn from FNB on a five-year fixed deposit, the gain might not appear so impressive though you would of course have to pay tax on the interest which would have probably negated the difference.

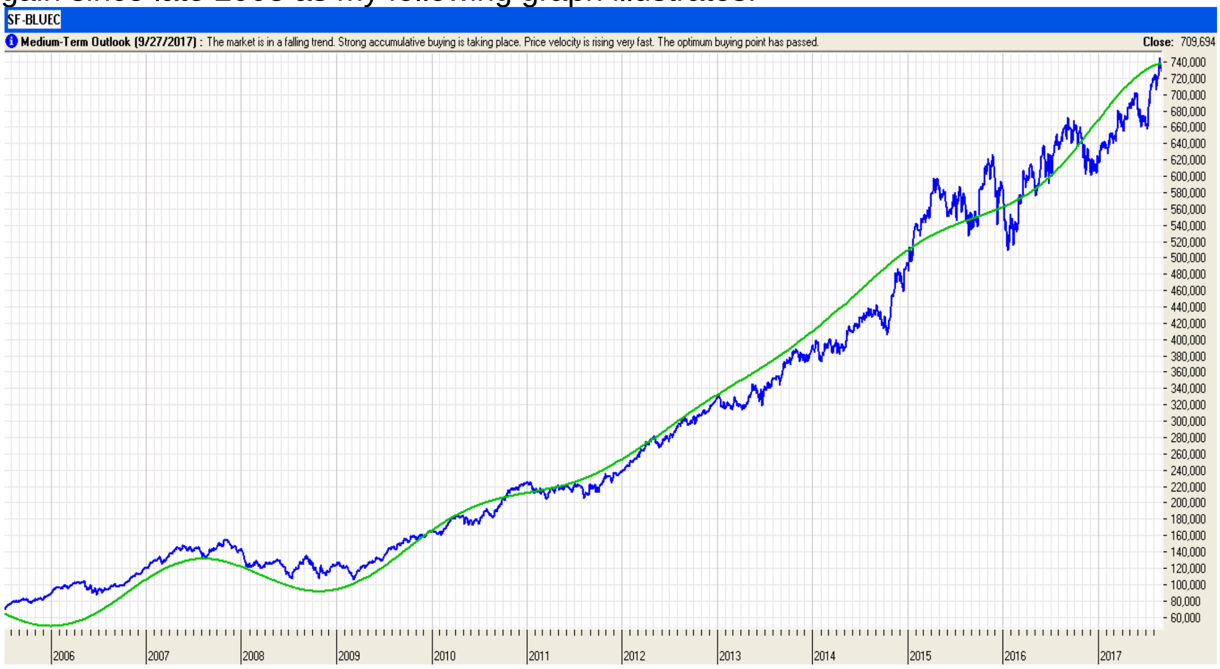
However, as my next graph indicates, had you invested in a cross section of the category of shares that my ShareFinder system identifies as London Stock Exchange Blue Chips, during that period you would have achieved, in Pound terms, compound 9.75 percent capital growth together with an annual average dividend yield of 3.6 percent representing a total return in Pound terms of 13.35 percent which, converted to Rands would have thus given our investor a total annual increase of 19.15 percent.

So, was it worth the effort and expense of applying for permission to ship Rands to Britain, opening a brokerage account there and setting up structures to facilitate offshore ownership such as a foreign trust in order to avoid the complications of high British death duties should the structure still be in place at your death?

The answer is a resounding NO. As my graph below illustrates, had you utilised the ShareFinder programme to isolate a list of South African Blue Chips back in 1987 and held them throughout the next 30 years you would have enjoyed compound annual average growth of 21.2 percent together with an average dividend yield of 3.7 percent making a Total Return of 24.9 percent.



What would that have meant in actual terms had you, for example, invested R100 000 back in 1987? Well the London investment, converted back into Rands today, would have given you R22 851 539. Had you invested the same amount into South African Blue Chips your investment would today be worth R 98 499 855.
But before I leave the subject, I would like to direct you to the snaking green lines on my topmost and second graphs. They represent how ShareFinder predicted these markets would move week by week throughout the 30 years which have allowed ShareFinder users to anticipate the timing of the points when a rising currency or share value turned around and became a falling trend and, of course, vice versa. If you study them you will see that they were not quite accurate in 2002 and 2008 but have become increasingly so in recent years, so much so that our forecast accuracy rate as detailed at the end of this letter every Friday, has now reached 91.43 percent. The reason for this is that artificial intelligence systems, like the one built into ShareFinder, require large amounts of historic data in order to achieve forecast accuracy. Ten years ago I thought there was a glass ceiling at 82 percent because ShareFinder never seemed able to better that figure and then in recent years the accuracy rate began creeping steadily upwards at around one percentage point a year.
It is beyond the scope of this article to calculate what your overall gain would have been had you taken yourself to a tax haven where Capital Gains Tax was not as destructive as it is in South Africa and there used ShareFinder’s projection system to trade in and out of securities in order to multiply your gains, but it is clear if you study the signals that those green lines provide, you could further multiply your gains by a factor of up to ten. To do so, however, you would need to stray outside the quality of shares that generally represent the Blue Chips which have been in almost constant gain since late 2008 as my following graph illustrates:



Market volatility keeps falling

By John Mauldin

Longtime readers know that I read a wide range of newsletters, articles, and websites every day. There are times when I see patterns in the information flow that are like puzzle pieces begging to be put together. I have been struck in the past few days by the amount of analysis and number of data sets that are all pointing to the same conclusion: There is a bull market in complacency.

Strange things are happening out there. One formerly successful billionaire hedge fund manager after another throws in the towel, sending the money in their funds back to the clients, confessing that they don't know how to handle these markets. I am reminded of the surrender of Cornwallis to Washington at Yorktown in 1781. Tradition has it that, as the British surrendered, their band played the old English folk tune "The World Turned Upside Down."

The inability of so many active funds to find that "edge" that formerly allowed them to produce alpha is quite remarkable. I have written about this phenomenon before, so I won't go into detail here; but it is the massive move from active to passive funds that is the core of the problem. Passive investing simply allocates among a number of index funds that indiscriminately buy or sell the stocks that are in their indexes.

That means if you buy an index fund for the Russell 2000 (small-cap stocks), not only are you getting the stocks of well-run companies, you are also buying the 30% of the small-caps that have less than zero earnings. And since we're seeing literally hundreds of billions of dollars moving to passive investing and away from active managers every year, that is a lot of indiscriminate buying. Barron's estimates that passive investments could make up half of all US equity retail flows in 2018 and 2019, and this calendar year will see the largest ever dollar shift in assets under management from active to passive. Part of the reason is a general move to lower fees, and part is simply that active management has failed to outperform.

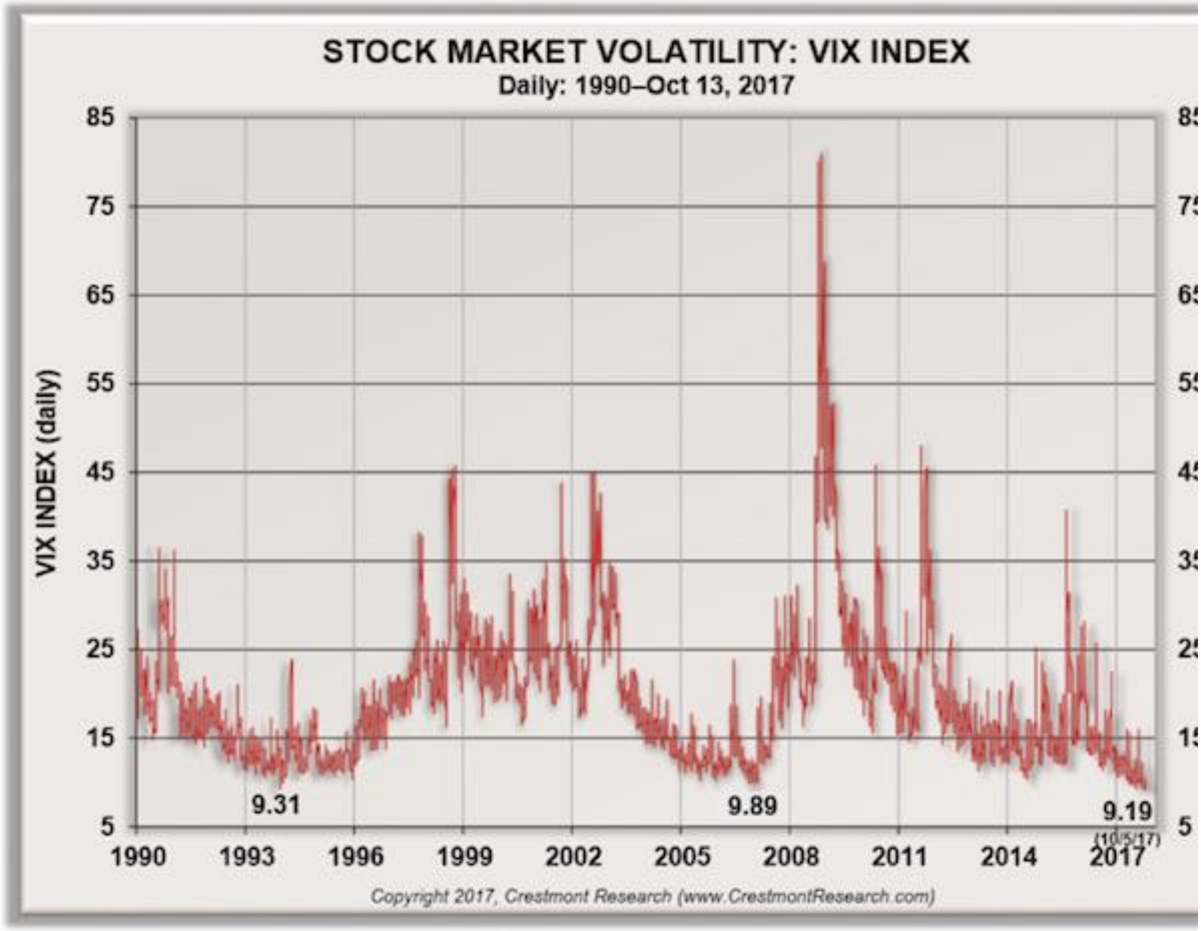
Here's the problem: It is extremely difficult for an active manager to buy the best companies and/or short the worst companies and show much outperformance relative to the passive index funds. No matter how much research you do, no matter how well you know those companies, your research is not giving you an edge over the massive movement to passive investing.

And if you have no edge, you have no alpha. It is just that simple. Personally, I don't think this is the end of active investing, but the game is going to have to change.

Where Has the Volatility Gone?
I was talking with Ed Easterling of Crestmont Research about the markets, and he asked me if I knew that there have been 39 times since 1990 when the VIX has closed below 10, and that 30 of those times have happened this year. And since the VIX has closed below 10 for the last two days since Ed and I talked, it is now 32 of 41 closes below 10. And 15 of those

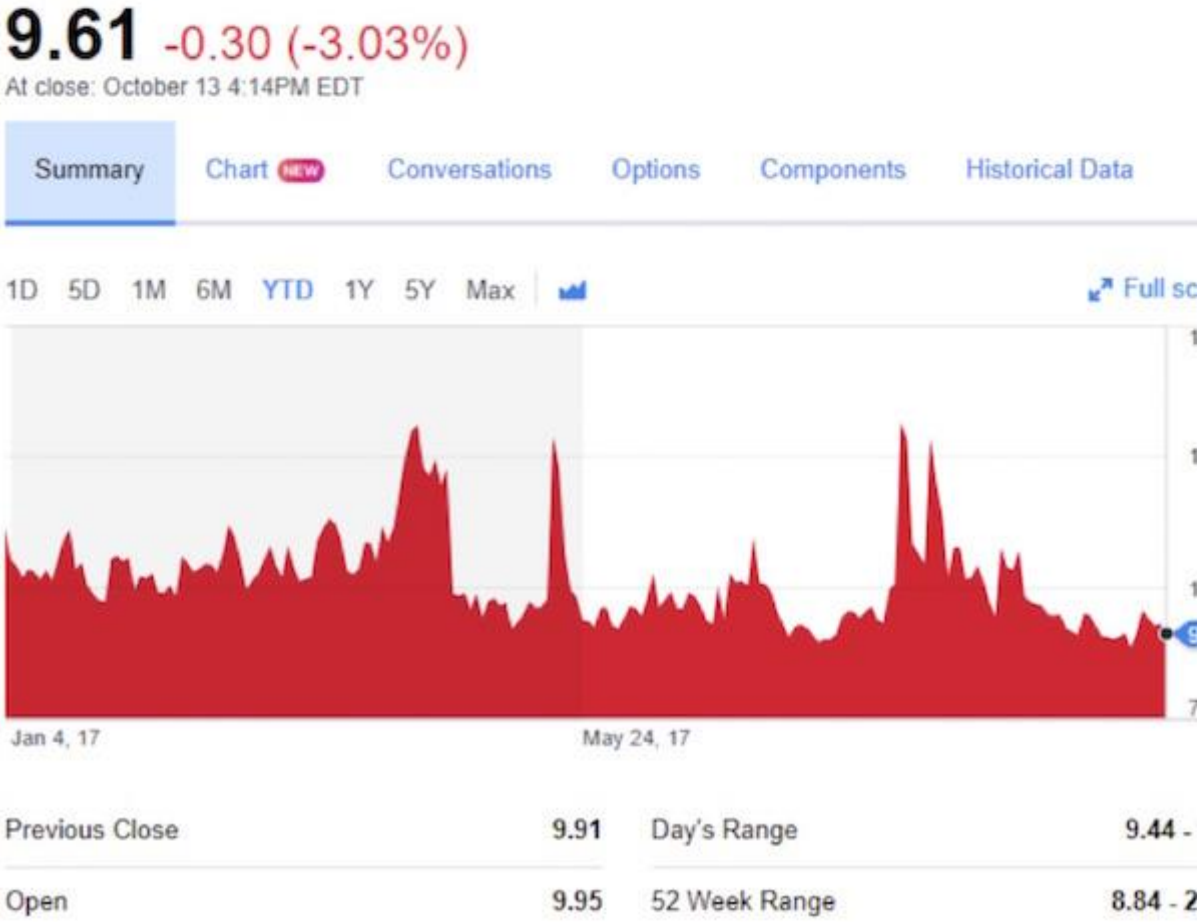
have been in the last 30 days!

Ed sent me an updated chart last night of the VIX Index through the close of the markets on Friday. Notice that the all-time low of 9.19 was put in on October 5, 2017.



All the previous sub-10 closes occurred in only two periods: Four of them were in the winter of 1993–1994 (around Christmas, which is traditionally a light trading period), and the others were in the winter of 2006–2007, another period of great complacency.

You can't really draw any conclusions about the next move of the markets, because the VIX could spike to 50 or stay in this low range for a very long time. Essentially, we have trained investors to "buy the dips," and that mentality removes a lot of volatility. Here is a chart of the VIX since the beginning of the year (from Yahoo Finance):



I got a blitz email tutorial this week from my friend Doug Kass, of Seabreeze Capital, a writer for the Street.com and Real Money Pro. He generally puts out two to three short pieces a day with his observations on the markets, and he discusses what stocks he is trading.
I was particularly struck with his observation about the massive – and it truly is massive – short position in the VIX and VIX futures. Look at this chart:

Now, as my friend and fellow Mauldin Economics writer Jared Dillian notes, prior to 2006 it was not possible for retail investors to trade the VIX. Then an ETF was created, and options and futures became available. Prior to that time it was just professionals who could create the effect of the VIX with futures and options trade positioning on the S&P. You almost had to be a pit trader to be able to do it.

Understand, the VIX is a totally artificial construct. It is a derivative of a derivative. In the beginning, around 1993, the VIX basically measured the implied volatility of eight S&P 100 at-the-money put and call options. Let's go to Investopedia for a quick tutorial:

> What is the VIX - CBOE Volatility Index?
> VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking, is calculated from both calls and puts, and is a widely used measure of market risk, often referred to as the "investor fear gauge."
> Breaking down the VIX - CBOE Volatility Index
> The CBOE designed the VIX to create various volatility products. Following the CBOE's lead, two other variations of volatility indexes have since been created: the VXN, which tracks the NASDAQ 100; and the VXD, which tracks the Dow Jones Industrial Average (DJIA).
> The VIX, however, was the first successful attempt at creating and implementing a volatility index. Introduced in 1993, it was originally a weighted measure of the implied volatility of eight S&P 100 at-the-money put and call options. Ten years later, in 2004, it expanded to use options based on a broader index, the S&P 500, which allows for a more accurate view of investors' expectations on future market volatility. VIX values greater than 30 are generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets.
> How the VIX's value is established
> The VIX is a computed index, much like the S&P 500 itself, although it is not derived based on stock prices. Instead, it uses the price of options on the S&P 500, and then estimates how volatile those options will be between the current date and the option's expiration date. The CBOE combines the price of multiple options and derives an aggregate value of volatility, which the index tracks.
> While there is not a way to directly trade the VIX, the CBOE does offer VIX options, which have a value based on VIX futures and not the VIX itself. Additionally, there are 24 other volatility exchange-traded products (ETPs) for the VIX, bringing the total number to 25.
> An example of the VIX
> Movements of the VIX are largely dependent on market reactions. For example, on June 13, 2016, the VIX surged by more than 23%, closing at a high of 20.97, which represented its highest level in over three months. The spike in the VIX came about due to a global sell-off of U.S. equities. This means global investors saw uncertainty in the market and decided to take gains or realize losses, which caused a higher aggregate equity supply and lower demand, increasing market volatility.

So there you have it. The VIX is simply a way to measure the future expectations of investors regarding the volatility of market prices. And lately, investors have been rewarded for shorting the VIX. It is almost like the experiments you see where rats learn that if they punch a button that they get a grape. Investors have learned that if they short the VIX they make a profit.

Except that now there are so many people on that side of the boat that when the boat starts to turn over, the rush to get the other side is going to rock that boat hard, possibly to the point of swamping it. Doug warns that a 2% or 3% move down in the markets could cause short covering in the VIX that could quickly spiral out of control. Not unlike the "portfolio protection" trade that brought about the 1987 crash.

A Bull Market in Complacency

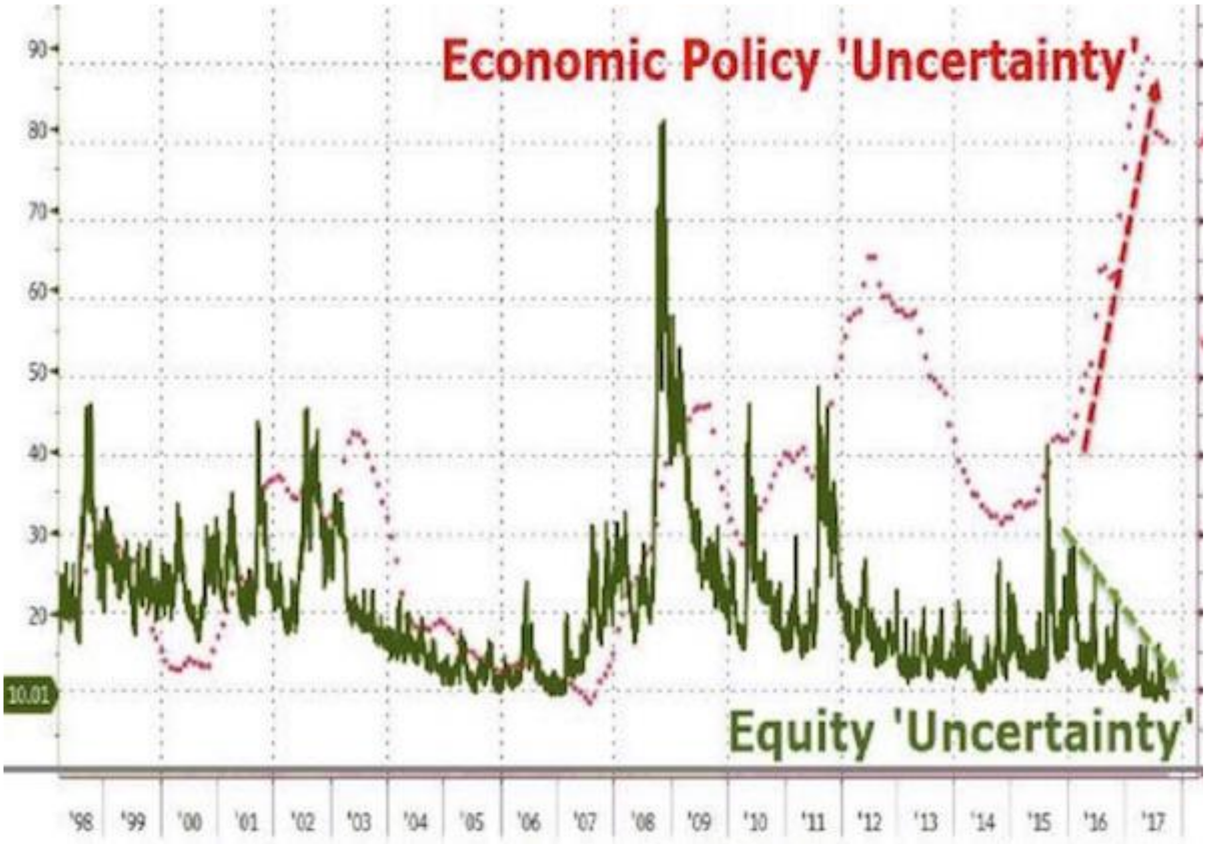
Peter Boockvar sent me a screen capture from his Bloomberg. The University of Michigan's Surveys of Consumers have been tracking consumers and their expectations about the direction of the stock market over the next year. We are now at an all-time high in the expectation that the stock market will go up.

It is simply mind-boggling to couple that chart with the chart of the VIX shorts. Writes Peter:

> Bullish stock market sentiment has gotten extreme again, according to Investors Intelligence. Bulls rose 2.9 pts to 60.4 after being below 50 one month ago. Bears sunk to just 15.1 from 17 last week. That's the least amount since May 2015. The spread between the two is the most since March, and II said, "The bull count re-enters the 'danger zone' at 60% and higher. That calls for defensive measures."
>
> What we've seen this year the last few times bulls got to 60+ was a period of stall and consolidation. When the bull/bear spread last peaked in March, stocks chopped around for 2 months. Stocks then resumed its rally when bulls got back around 50. Expect another repeat.

Only a few weeks ago the CNN Fear & Greed Index topped out at 98. It has since retreated from such extreme greed levels to merely high measures of greed. Understand, the CNN index is not a sentiment index; it uses seven market indicators that show how investors are actually investing. I actually find it quite useful to look at every now and then.

The chart below, which Doug Kass found on Zero Hedge, pretty much says it all. Economic policy uncertainty is at an all-time high, yet uncertainty about the future of the markets is at an all-time low.



At the end of his email blitz, which had loaded me up on data, Dougie sent me this summary:

> At the root of my concern is that the Bull Market in Complacency has been stimulated by:
> * the excess liquidity provided by the world's central bankers,
> * serving up a virtuous cycle of fund inflows into ever more popular ETFs (passive investors) that buy not when stocks are cheap but when inflows are readily flowing,
> * the dominance of risk parity and volatility trending, who worship at the altar of price momentum brought on by those ETFs (and are also agnostic to "value," balance sheets," income statements),
> * the reduced role of active investors like hedge funds – the slack is picked up by ETFs and Quant strategies,
> * creating an almost systemic "buy on the dip" mentality and conditioning.
> when coupled with precarious positioning by speculators and market participants:
> * who have profited from shorting volatility and have gotten so one-sided (by shorting VIX and VXX futures) that any quick market sell off will likely be exacerbated, much like portfolio insurance's role in a previous large drawdown,
> * which in turn will force leveraged risk parity portfolios to de-risk (and reducing the chance of fast turn back up in the markets),
> * and could lead to an end of the virtuous cycle – if ETFs start to sell, who is left to buy?

The chart above, which shows the growing uncertainty over the future direction of monetary policy, is both terrifying and enlightening. The Federal Reserve, and indeed the ECB and the Bank of Japan, went to great lengths to assure us that the massive amounts of QE that they pushed into the market would help turn the markets and the economy around.

Now they are telling us that as they take that money back off the table, they will have no effect on the markets. And all the data that I just presented above tells us that investors are simply shrugging their shoulders at what is roughly called "quantitative tightening," or QT. I can understand the felt need by central bankers to “reload the gun” by raising rates so they will have a few bullets left to fire during the next downturn. Though frankly, I think that if they simply left the market to itself, very short-term rates wouldn’t be all that high. I mean, if 30-year Treasuries are still below 3%, what does that tell you about inflation expectations, and what does that tell you about expectations for short-term money market instruments?

Admittedly, the amount of QT this year is rather de minimis. But then it begins to rise quickly. At least two of those on the short list for Fed chair, in their recent speeches, have been critical of the Fed for not raising rates more forcibly; and while they haven’t explicitly commented on the balance sheet, they presumably would be inclined to continue with its reduction.
I simply don’t buy the notion that QE could have had such an effect on the markets and housing prices while QT will have no impact at all. In the 1930s, the Federal Reserve grew its balance sheet significantly. Then they simply left it alone, the economy grew, and the balance sheet became a nonfactor in the following decades.

I don’t know why today’s Fed couldn’t do the same thing. There is really no inflation to speak of, except asset price inflation, and nobody really worries about that. We all want our stocks and home prices to go up, so there’s no real reason for the central bank to lean against inflationary fears; and raising rates and doing QT at the same time seems to me to be taking a little more risk than necessary. And they’re doing it in the midst of the greatest bull market in complacency to emerge in my lifetime.

Do they think that taking literally trillions of dollars off their balance sheet over the next few years is not going to have a reverse effect on asset prices? Or at least some effect? Is it really worth the risk?

Remember the TV show ***Hill Street Blues?*** Sergeant Phil Esterhaus would end his daily briefing, as he sent the policemen out on their patrols, with the words, “Let’s be careful out there.”

Testing Washington’s Commitment to Asia

By George Friedman and Jacob L. Shapiro

China’s 19th National Congress of the Communist Party is garnering a lot of attention right now, and rightly so. In a speech during the opening ceremony of the conference, President Xi Jinping heralded the beginning of a new era in China, but he was also surprisingly honest about the inadequacy of his first term. Although the congress will continue into this week—there are still important things to be decided, chief among them whether Xi will anoint a successor, as is tradition in China, or whether he will continue to rule as dictator in perpetuity—most of the major events have already taken place.

Much of Asia had been in something of a holding pattern in the lead-up to the congress. But now, that holding pattern is over, and we can look ahead to some key events in the region that will reverberate throughout the world in the weeks to come.

Japan in a Tough Spot

In Japan, Prime Minister Shinzo Abe's coalition decisively won another term in elections over the weekend. It is a remarkable political comeback for Abe, who gambled that he could overcome some of the scandals dogging his regime and win another mandate, allowing him to continue his economic reforms and to push the country toward the controversial step of revising its pacifist constitution.

Abe can thank North Korea in part for his political resurgence. North Korea's launching of missiles over Japan and the inability to halt Pyongyang's nuclear program have given Abe new life. But the important issue here is not so much Abe as it is a potential shift in Japan's overall posture. Although China conceded to some of its weaknesses during the National Congress, Japan cannot bet that China will remain weak, no matter how difficult China's problems are.

The inability of the US to control the situation in North Korea, moreover, raises hard questions for Japan. A country shielded by a US security guarantee can afford to be a pacifist nation, but a country highly dependent on raw material imports and threatened by an adversary that may soon become a nuclear power cannot. Add to this the fact that Japan conquered much of the Asian coast in the early 20th century and treated its colonial subjects as inferiors. This leaves Japan in a tough spot. Japan has no shortage of enemies, and it can't count on the US to prevent North Korea from acquiring a nuclear weapon. Japan will have to fend for itself.

Meanwhile, North Korea remains as recalcitrant as ever. In the past week, Pyongyang has threatened imminent nuclear war against the United States and vowed to "mercilessly smash the war frenzy of the US and South Korean puppet warmongers" in response to US-South Korean naval drills. This theatrical language is typical for the North Koreans. But there are some statements related to the North Korean crisis that shouldn't be dismissed. Last week, the CIA director said that North Korea was on the verge of possessing nuclear weapons capable of striking the US—and that President Donald Trump was resolute in not allowing that to happen.

US Commitment to Asia

It is with all of this uncertainty swirling that Trump will travel to five Asian countries—Japan, South Korea, China, Vietnam, and the Philippines—in early November. It's a fitting trip for the one-year anniversary of Trump's election.

Trump's visits to Japan, South Korea, and the Philippines are aimed at demonstrating that the US is still committed to Asia, and not only because of North Korea. Photo ops, however, won't be enough to prove this commitment. Japan and South Korea will want to know what the US plans to do about Pyongyang, while the Philippines wants to know whether it can still depend on the US to protect its interests—or whether it should cut a deal with China now while it has all the leverage.

Trump's trip to Vietnam is proof of a fundamental premise in geopolitics: Individual leaders don't matter nearly as much as most people think they do. A country's foreign policy will change very little when a new president takes office. President Barack Obama lifted an arms embargo against Vietnam during a visit to Hanoi. Now, President Trump is set to take his own trip to the communist country. The two nations may have an uneasiness toward each other because of the Vietnam War, but they share an interest in containing China, and this is more important than ideology and their historical animosity. Trump won't eat noodles with Anthony Bourdain on the streets of Hanoi, as his predecessor did, but like Obama, he will look to strengthen the bilateral relationship with an eye toward isolating China in the region as much as possible.

This leads us, of course, to China. It remains unclear precisely what Trump plans to do when he meets the Chinese president on his home turf. When they last met in April, Xi agreed to help the US contain North Korea in exchange for the Trump administration's backing off some of its promises to punish Beijing for what it sees as unfair trade practices. Six months later, there has been no tangible progress on North Korea, and some of the more hawkish, anti-China voices in Trump's ear have been sidelined… Steve Bannon most notable among them. And now, according to ***Politico***, the White House is reportedly conducting a comprehensive, bottom-up review of its China policy.

Rumors are swirling over what could result from Trump's trip to China. Some think that he will announce some kind of major US-China agreement on how the two will coexist in the global economy. Others expect this to be a tougher conversation—a last ditch effort by Washington to impress upon Beijing what the cost would be of failing to make progress on North Korea. The only things that can be known for certain are that the US is not getting what it wants out of China and China cannot give the US what it wants.

Whatever pleasantries are exchanged between China and the US won't solve these issues, nor will Trump's photo ops with other heads of state solve the North Korea issue. Until the US decides what it will do about North Korea, its policy in Asia will remain hostage to Kim's regime in Pyongyang. This plays into China's hands and leaves other US partners looking for alternatives.