The Investor©

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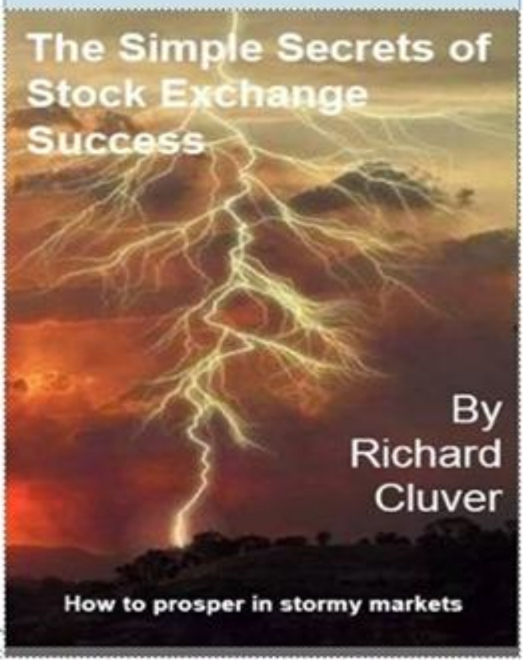
Facing the future

By Richard Cluver



I have looked to the future and it is deeply troubling if we fail to take the precautions that are now staring us in the face.

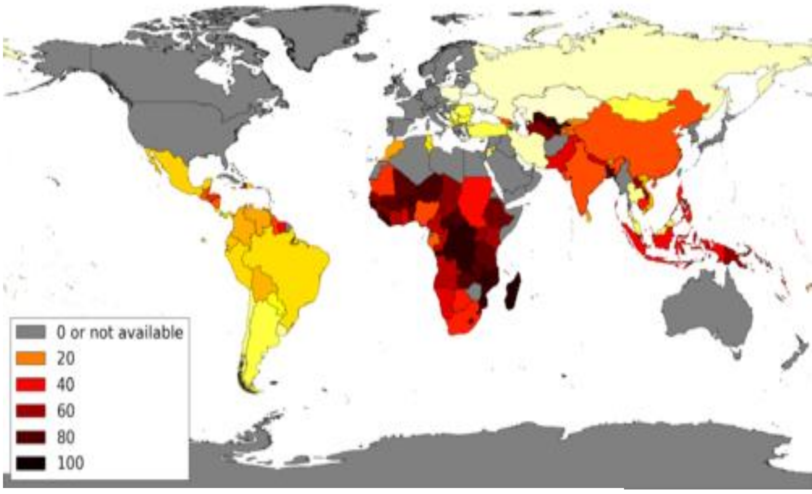
Noting economic projections which suggest that advances in medical science have ensured that half of the children born since 1993 will live to see their 150th birthdays, readers might recall our July edition of ***The Investor*** in which I projected that if South Africa's population growth rate of the past 100 years did not slow significantly we will number 1.75-billion by the time our grandchildren start shuffling off.

As a consequence of migration to urban living and AIDS, our population growth rate has in fact slowed in recent years from the 2.246 percent rate of the past century to a current 1.8 percent and that will have dramatic consequences. Instead of having to find jobs and homes and a means of feeding nearly the current population of India, our population will only have increased to 906-million. That is ONLY 15 times our current population.

But therein lies a conundrum of its own because if half the population is likely to attain twice the current average life span, then it is clear that the current birth rate slow-down will be negated by longevity. So 15-times the current population number might be very conservative!

Generation Z as they have been dubbed, are on average around 18 years of age today and just entering university. They are likely to keep on working until they reach the age of 100 - and they will need to do so if they are to accumulate enough to afford to live in retirement for another 50 years after that. The good news, however, is that they are likely to look and feel like our current 60-year-old retirees.

However, before they can think of retirement they will need to solve a number of very serious problems for which, to date the world has found no answers. To list just some of the more obvious ones they will need to solve the problems of unemployment. The world map on the right is colour coded according to the degree of poverty in each country. Note that the map of Africa ranges from 40 to 100 percent of the population trapped in poverty.



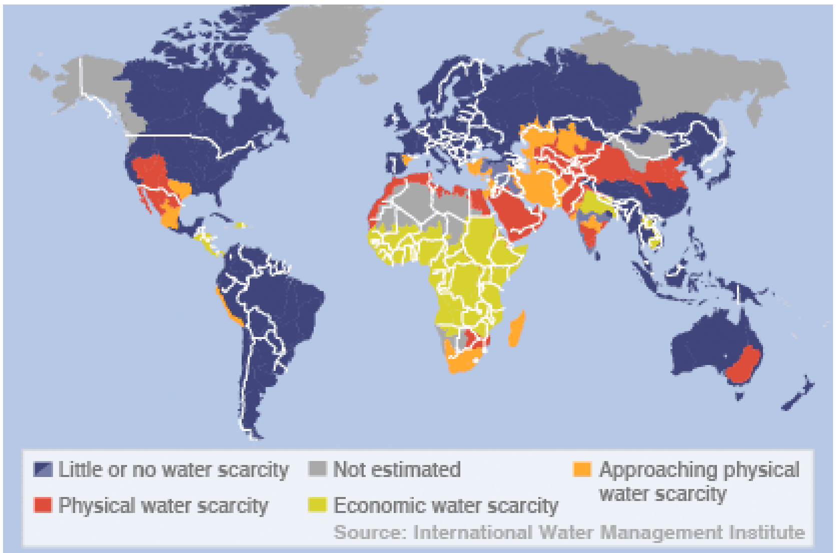
Globally it is estimated that 201-million people, representing about 5.8 percent of populations, are without work. But here in South Africa, thanks to the dismal failure of the ANC to effectively address the issue, one in three people is out of work and the great majority of them are young people.

And it has been steadily worsening which is the fundamental reason why our crime rate is so high and why most new residential development is within gated communities. Our murder rate is five times the global average...the world's third highest...and similar figures exist for most other crime categories.

So it is hardly surprising that collectively the more affluent in our society are, figuratively speaking, building castles for themselves and digging moats around them to keep out the poor. Ultimately however, we will have to find a way to level the playing fields or by their sheep weight of numbers the poor will overwhelm those who can afford to live in enclosed communities.

But rather than finding ways to employ the poor, we have globally directed our resources towards the development of artificial intelligence: robotics is displacing manual workers in our work places. To illustrate this the Changing Precision Technology Company in China used to be run by 650 employees, but now just 60 people get the entire job done, while robots take care of the rest. Furthermore that number is ultimately expected to drop to just 20. Despite this reduction in staff, not only is the factory producing more equipment (a 250% increase), but it's also ensuring better quality.

As many observers have noted, robots don't strike for more pay, are happy to work 24 hours a day 365 days a year and are a lot cheaper than the humans they replace. There is now a growing realisation that artificial intelligence will take over more than a third of jobs in the developed world at precisely the time when populations are expanding on a scale the world has never seen before.



Next note that much of this planet is already short of water with Africa the most water-stressed. The United Nations (UN) estimates that, of 1.4-

billion cubic kilometers of water on Earth, just 200,000 cubic kilometers represent fresh water available for human consumption.

More than one in every six people in the world is water stressed, meaning that they do not have sufficient access to potable water. There are 1.1 billion water stressed people in the world and are all living in developing countries.

In South Africa 19 percent of the rural population lacks access to a reliable water supply and 33 percent do not have basic sanitation services. While rural citizens suffer the most, over 26 percent of all schools and 45 percent of clinics, have no water access either.

Despite the apparent lack of water in South Africa, a large portion of South Africa's GDP is directly dependent upon water. For example, over 15 percent of its GDP comes from agriculture, which uses 60 percent of South Africa's water supply.

Another major problem for which we appear to have no answer whatsoever in the debt of nations. There are already 16 major nations whose net debt exceeds 100 percent of their Gross Domestic Product and those levels of debt have been steadily increasing for decades now. What happens when the entire tax revenue of a country is required merely to service interest payments on the debt?

South Africa is projected to reach 60 percent within the next year, the level beyond which it is generally agreed that governments are unable to repay their debt from normal taxation sources and far more so in our case given the tiny proportion of our population who are taxpayers.

Then there is Climate Change. The year we have just experienced has been recorded as the third hottest on average with some of the worst hurricanes in history having imposed catastrophic destruction across large swathes of the planet. In 2017 the world has witnessed floods in India and Nigeria, hurricanes in the Caribbean and wildfires in the US, South Africa and Europe collectively making it clear that global emissions urgently need to start falling.

Next is the problem of food security. Globally more than 2.5 million children die each year from malnutrition because of food insecurity with Sub-Saharan Africa having the highest rates of underweight children and infants: over 24% recorded between 2010 and 2012.
Halving hunger in the world was the first of the eight anti-poverty millennium development goals set in 2000, but improvements in food security have not happened fast enough or evenly across the world to have achieved this goal. Some 852-million people in developing countries do not have food security. Of these, 234 million live in Sub-Saharan Africa.

Next on my list are the super bugs. Drug-resistant infections are already a major problem in South Africa and it is getting worse, warned Prof Andrew Whitelaw, head of the Division of Medical Microbiology in the Faculty of Medicine and Health Sciences at Stellenbosch University.

"In hospitals, many of the bacteria (up to 60 or 70% in some centers) are resistant to most available antibiotics, leaving only one or two options available for treatment."

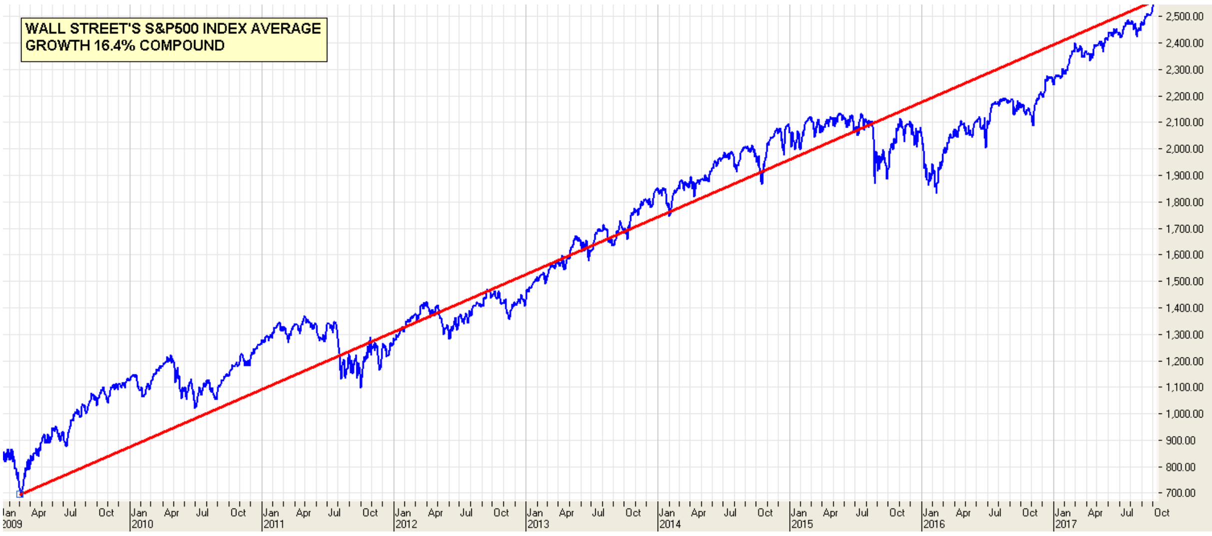
"We are also seeing bacteria that are resistant to all available antibiotics and that are essentially untreatable. Fortunately this is still relatively uncommon (compared to some other parts of the world), but the problem is likely to get worse."

This is exacerbated by the fact that there are few to no new antibiotics coming onto the market, said Prof Whitelaw. "What is coming out is usually a modification of an existing antibiotic, rather than a completely new antibiotic. Resistance to these modified antibiotics tends to develop fairly quickly."

So South Africa’s future does not look very good for our grandchildren. The easiest precaution might be to move to another country that is less exposed to these pressures. Here the best option might be New Zealand, the country which tops the list for having no water stress, one of the world’s lowest population densities and the ability to repay its national debt in just 13 months.

Most interesting, however, is that the best measure we have of the financial health of a country is the performance of its stock exchange, so consider how well the New Zealand exchange has performed over the past eight years, growing at an average of 14.3 percent compound every year.

It came second only with Wall Street’s blue chip S&P500 Index which achieved 16.4 percent compound.



That is, of course if you leave out South Africa’s Blue Chips which over the same period achieved 23.1 percent.

Despite all of our troubles, South African shares are actually still doing quite well. With degree of optimism, perhaps we might also have the nouse to deal with our other problems!

SA ECONOMY

The market tells us about the ANC succession battle

By Brian Kantor

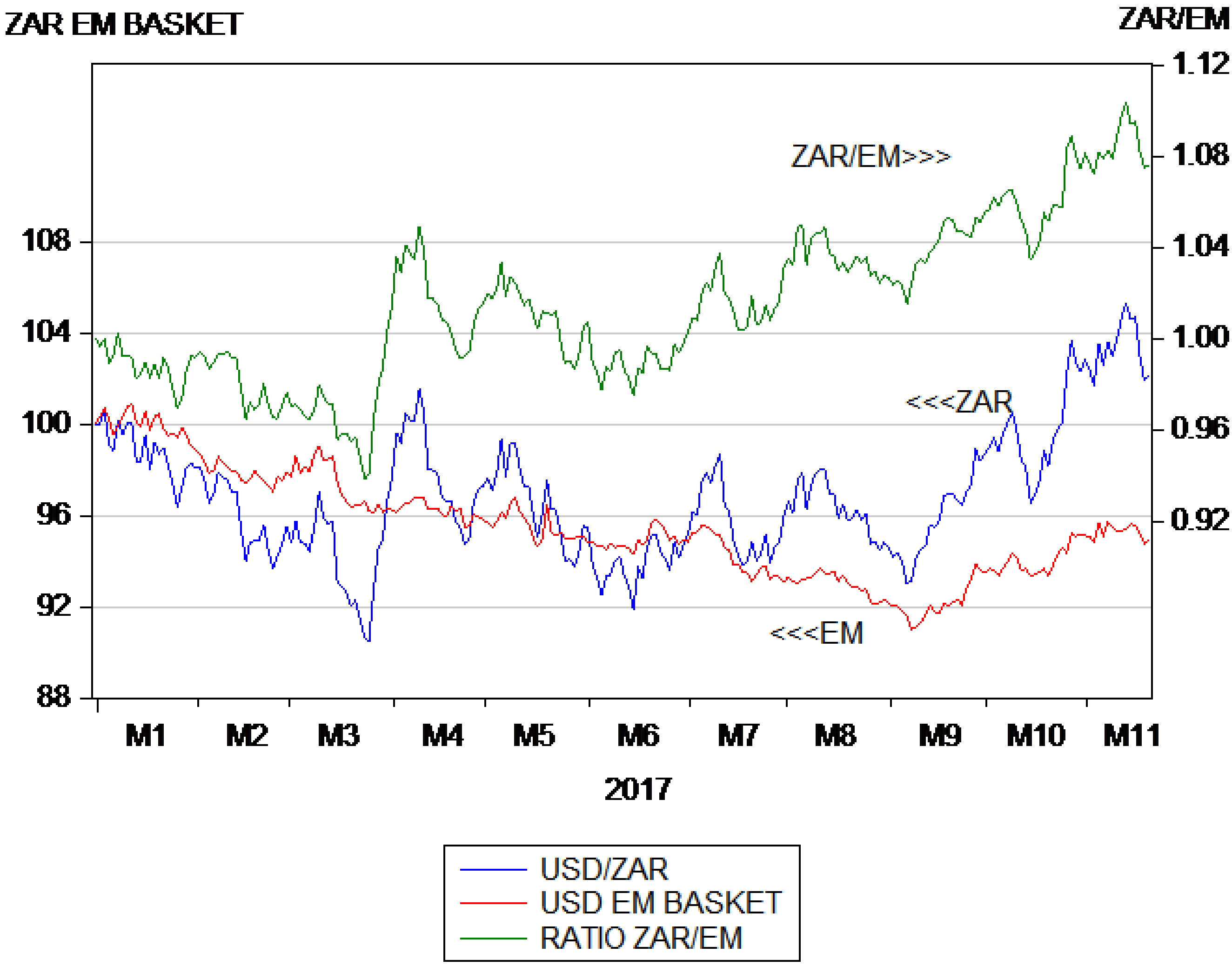
The outlook for the SA economy depends on who governs after December 2017. Will it be the Zuma faction or some other ANC coalition calling the shots? That is the essential question for the economy and the value of the financial claims on it. The market in SA assets has made its preferences for much less of President Zuma very clear. RSA risk premiums rise and fall as the expected Zuma influence on policy gains or loses momentum.

On Thursday and Friday last week the market registered less SA risk as the rand strengthened, not only against the USD, but more meaningfully the rand also gained against other EM exchange rates.[1] Furthermore not only did RSA bond yields decline late last week – they declined relative to benchmark US yields. The political developments that actually moved the market are however not that obvious.

The behaviour of these indicators in 2017 is shown in figure 1 below. As may be seen 2017, despite this recent improvement in sentiment, has not been a good year for the ZAR. It weakened relative to its EM peers when highly respected Finance Minister Pravin Gordhan was also sacked in March. It also suffered in response to the Budget statement of his successor in late October, as may also be seen.

The budget disappointment was perhaps not in the details about the revenue shortfall – that were well telegraphed – but that no revised plan to address the widening fiscal deficit was offered. The concern was presumably that Zuma and his cohorts would soon announce more rather than less government spending regardless of the fiscal constraints.

Fig.1; The USD/ZAR and the USD/EM exchange rate basket in 2017. Daily Data January 1st=100 or ratio (LHS) =1

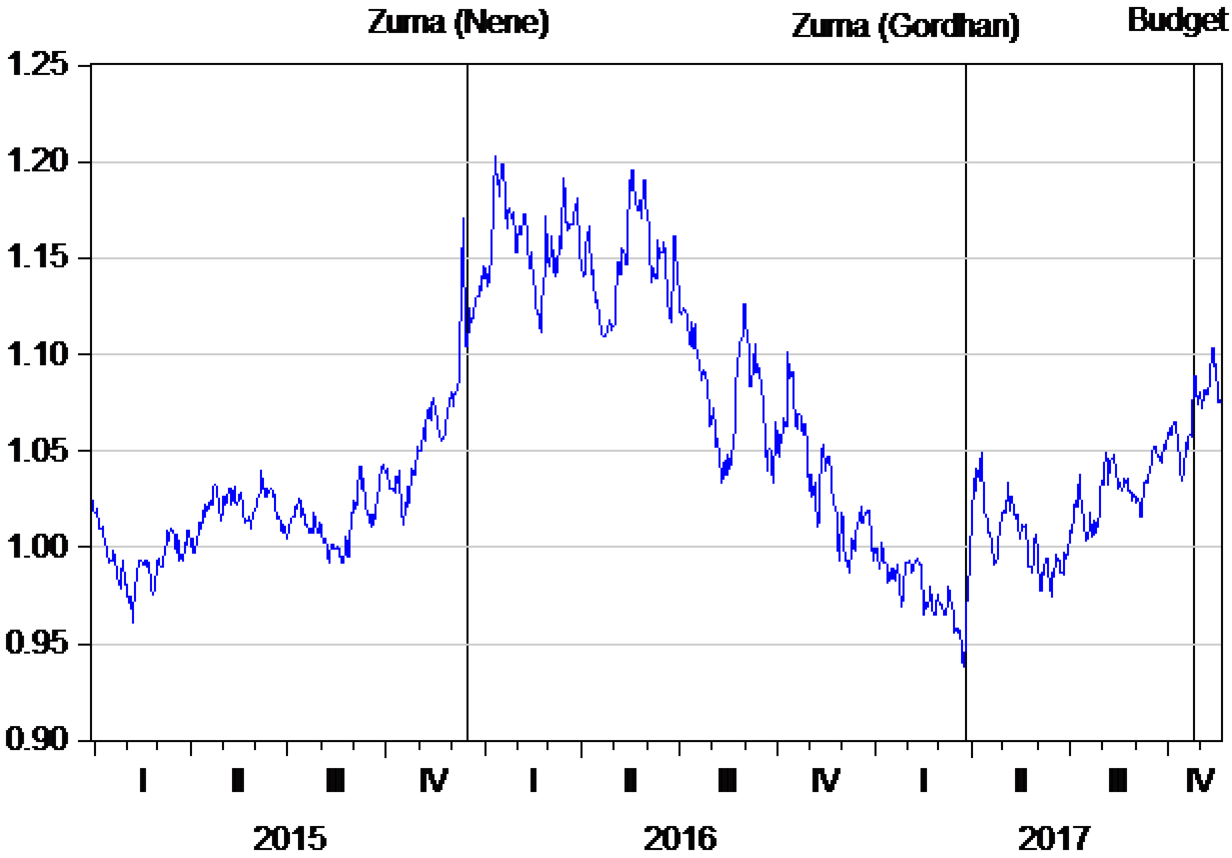


Source; Bloomberg and Investec Wealth and Investment

Though perhaps a little longer perspective on SA risk indicators is called for, as is provided in figure 2 below. There it may be seen that the ratio of USD/ZAR exchange rate to the USD/EM currency basket, weakened significantly in December 2015, when Finance Minister Nene was so surprisingly and ignominiously sacked. However as may be seen in the figure, the rand in a relative and absolute sense did very much better in 2016. Perhaps because the decision

Zuma made under pressure from colleagues and the business community to immediately reappoint Pravin Gordhan, indicated less rather than more power to the President. A sense perhaps that the market had gained of Zuma overreach and a degree of vulnerability. Just how vulnerable remains to be determined- hence market volatility.

Fig 2; the ratio of the USD.ZAR to the USD/EM currency basket (January 2017=1) Daily Data



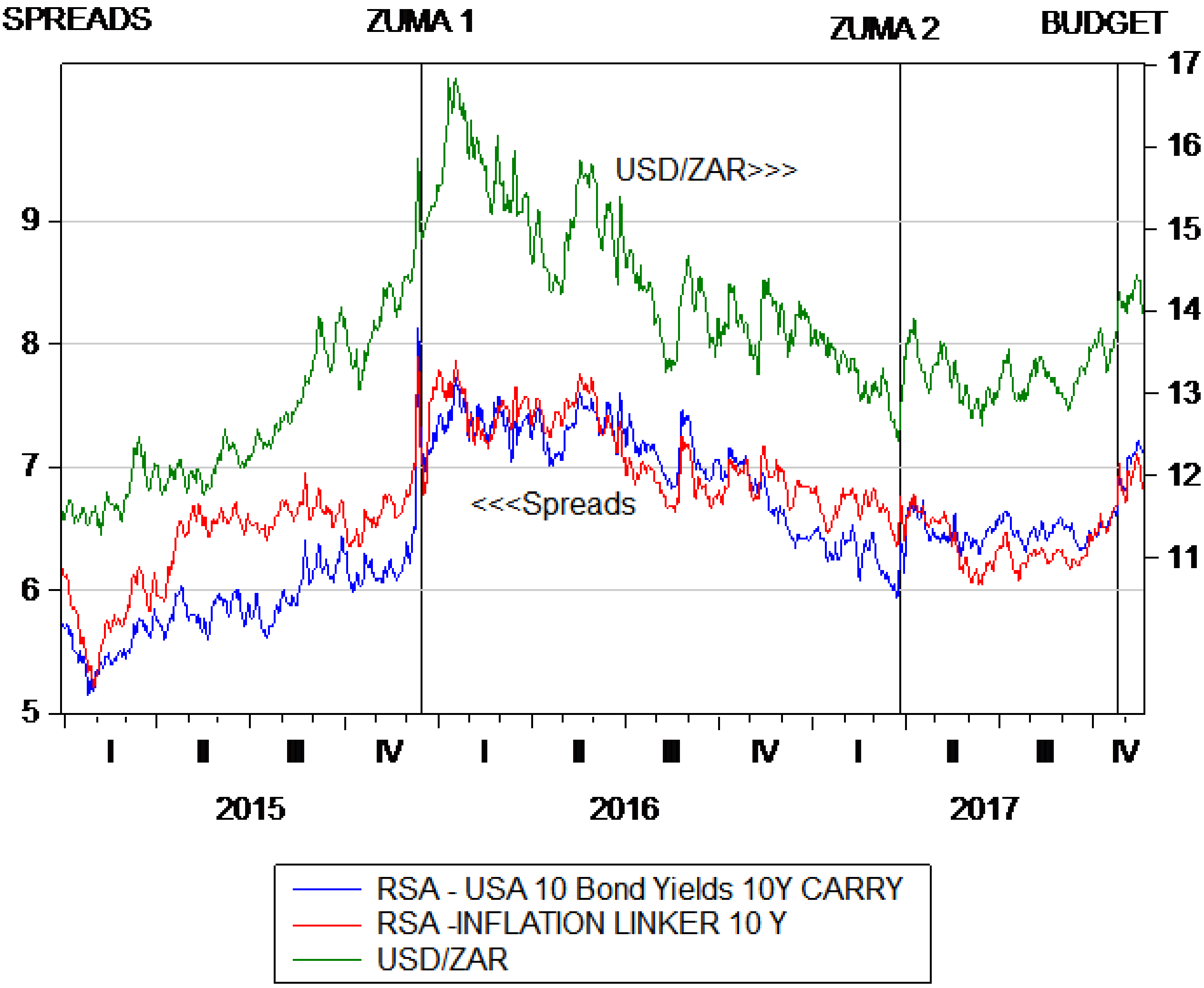
Source; Bloomberg and Investec Wealth and Investment

The indicators derived from the Bond market make the same statements about SA risk. As shown in figure 3 below, the spread between RSA and USA government bond yields, the so-called interest rate carry that reveals the expected depreciation of the USD/ZAR exchange rate widened sharply as the rand weakened in late 2015. They then narrowed through much of 2016, stabilized in 2017 until the Budget disappointment pushed them higher.

In figure 4 it may also be seen how the RSA sovereign risk premium has behaved in 2017. Sovereign risks are revealed by the spread between the yield on a USD denominated RSA (Yankee) Bond and its US equivalent. As may be seen this spread has been variable in 2017 – that it increased by 40 b.p. in October – and then declined sharply in the week ending on November 17th. These spreads indicate that SA debt was already being accorded Junk Status by the market place, ahead of any such ruling by the rating agencies. The spread on the lowest Investment Grade debt would be of the order of 1.6%.

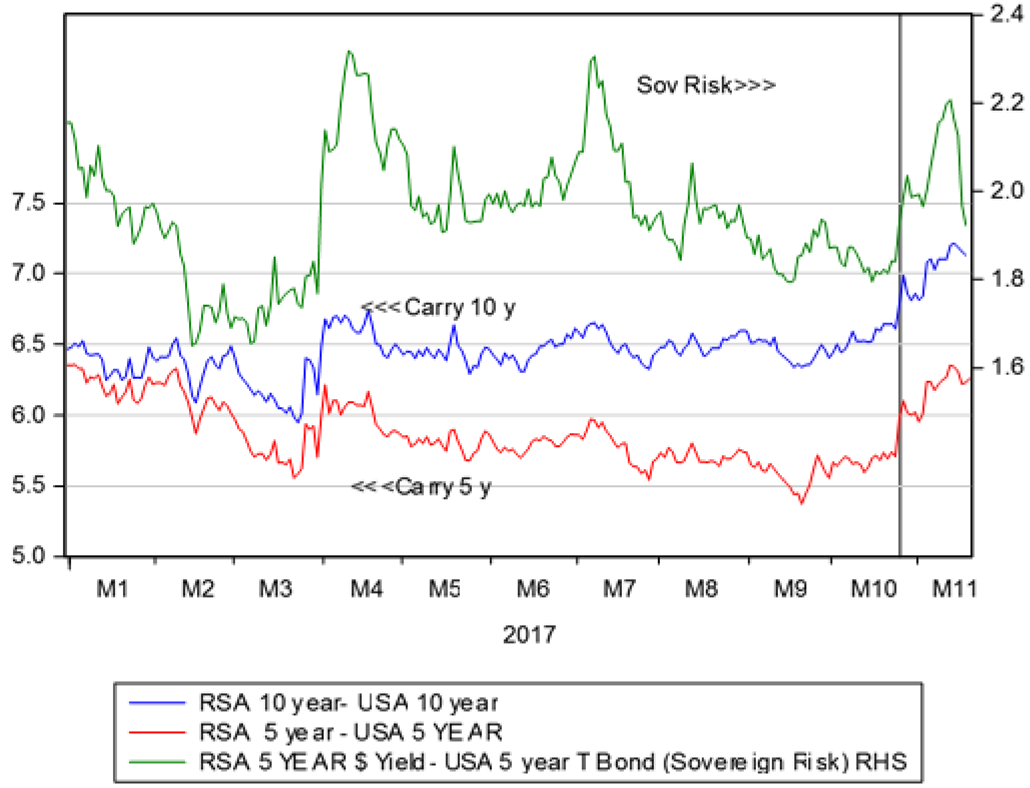
In figure 5 we show the interest carry- the rate at which the USD/ZAR is expected to weaken over the next ten years and inflation expectations. These are measured as the spread between a vanilla bond that carries inflation risk and an inflation linker of the same duration that avoids inflation risk. As may be seen more inflation expected is strongly connected to the rate at which the ZAR is expected to weaken. It should be recognized that the weaker the rand the more it is expected to weaken further. It will take a stronger rand to reduce inflation expected- a welcome development that is beyond the influence of interest rates themselves.

Fig.3; The USD/ZAR and the Interest Rate Spreads. Daily Data 2015-2017



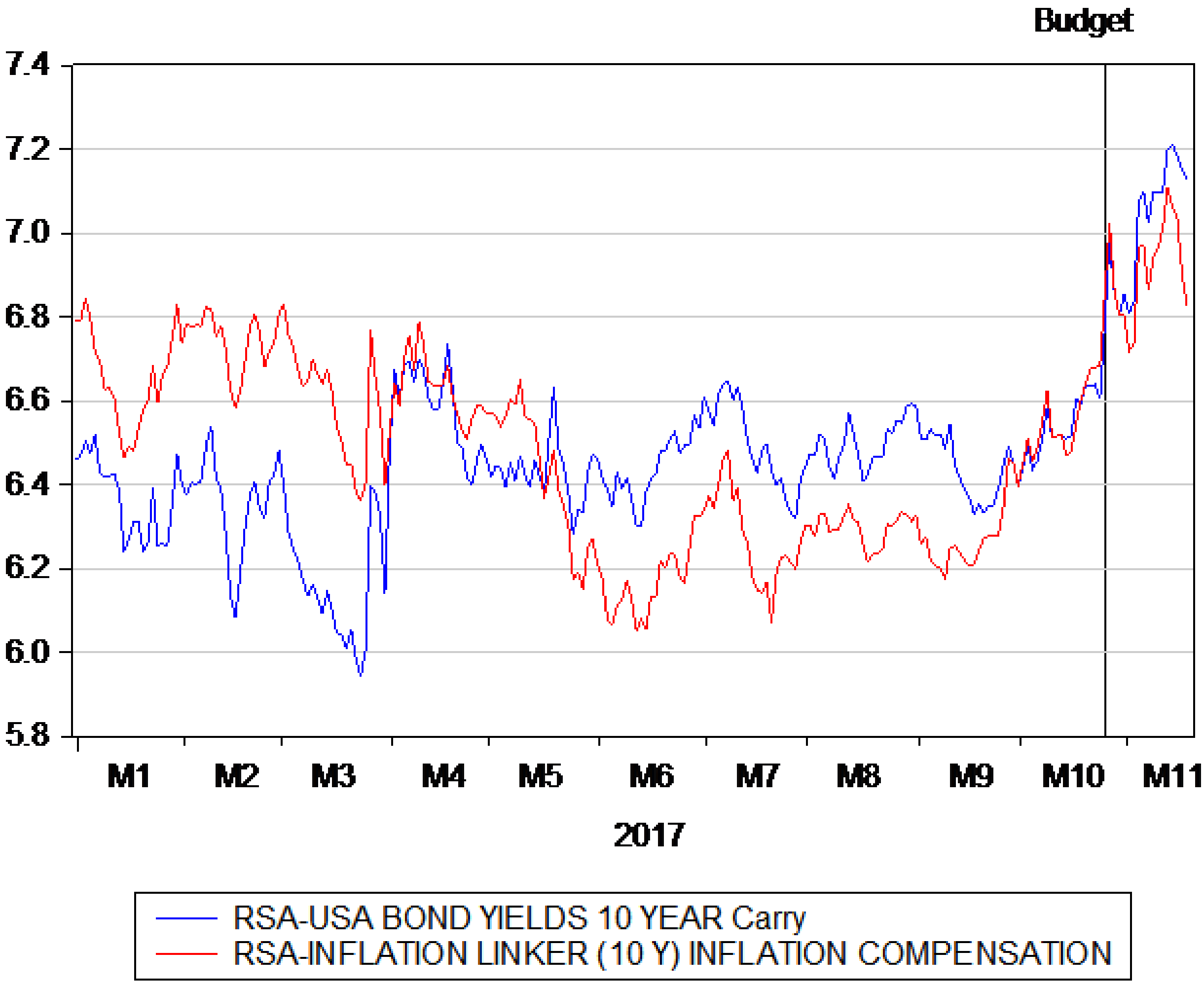
Source; Bloomberg and Investec Wealth and Investment

Fig.4; the RSA sovereign risk premium and the interest carry. Daily Data 2017.



Source; Bloomberg and Investec Wealth and Investment

Fig.5: The interest rate carry and inflation compensation in the RSA bond market. Daily Data 2017.



The market place, as well as the bookmakers, will continuously update the odds of one or other candidate for the Presidency of the ANC (probably) being determined in December 2017. The odds offered by Sportingbet at 13h00 on November 20, 2017 are shown in the Table below. (www.sportingbet.co.za) As they say in racing circles- the favourite does not always win- but don't bet against it.

Lower South African risks and the stronger rand and lower interest and inflation rates associated with rand strength are good for the economy and all the businesses and their stakeholders dependent on the economy. One prediction can be made with some degree of conviction. That is without less SA risk any cyclical recovery in the SA economy is unlikely.

2017 ANC Elective Conference Outcome 01:00 SAST 16/12/17

Next ANC President after Jacob Zuma	
Nkosazana Dlamini-Zuma	2.50
Zweli Mkhize	4.00
Cyril Ramaphosa	2.20
David Mabuza	101.00
Lindiwe Sisulu	101.00
Jeff Radebe	101.00
Mathews Phosa	101.00
None of The Above	17.00
Bets void if the next ANC president is not elected during the conference. Singles Only.	

[1] Our construct for Emerging Market exchange rates that exclude the ZAR is an equally weighted nine currency basket of the Turkish Lire, Russian Ruble, Hungarian Forint, Brazilian Real, Mexican, Chilean and Philippine Pesos, Indian Rupee and Malaysian Ringgit

Leverage, American Style

By John Mauldin

When I asked my “kitchen cabinet” of friends for instances of the absurd, Grant Williams sent a monumental slide deck. I guess I should have expected that, as the absurd is one of his specialties. My computer almost melted trying to download the deck, but it finally finished and was worth the wait. Here is just one example of craziness.

This chart is straightforward: its outstanding credit as a percentage of GDP. Broadly speaking, this is a measure of how leveraged the US economy is. It was in a sedate 130%–170% range as the economy industrialized in the late 19th and early 20th centuries. It popped higher in the 1920s and 1930s before settling down again. Then came the 1980s. Credit jumped above 200% of GDP and has never looked back. It climbed steadily until 2009 and now hovers over 350%.

Absurd doesn't do this situation justice. We are mind-bogglingly leveraged. And consider what the chart doesn't show. Many individuals and businesses carry no debt at all, or certainly less than 350% leverage. That means many others must be leveraged far higher.

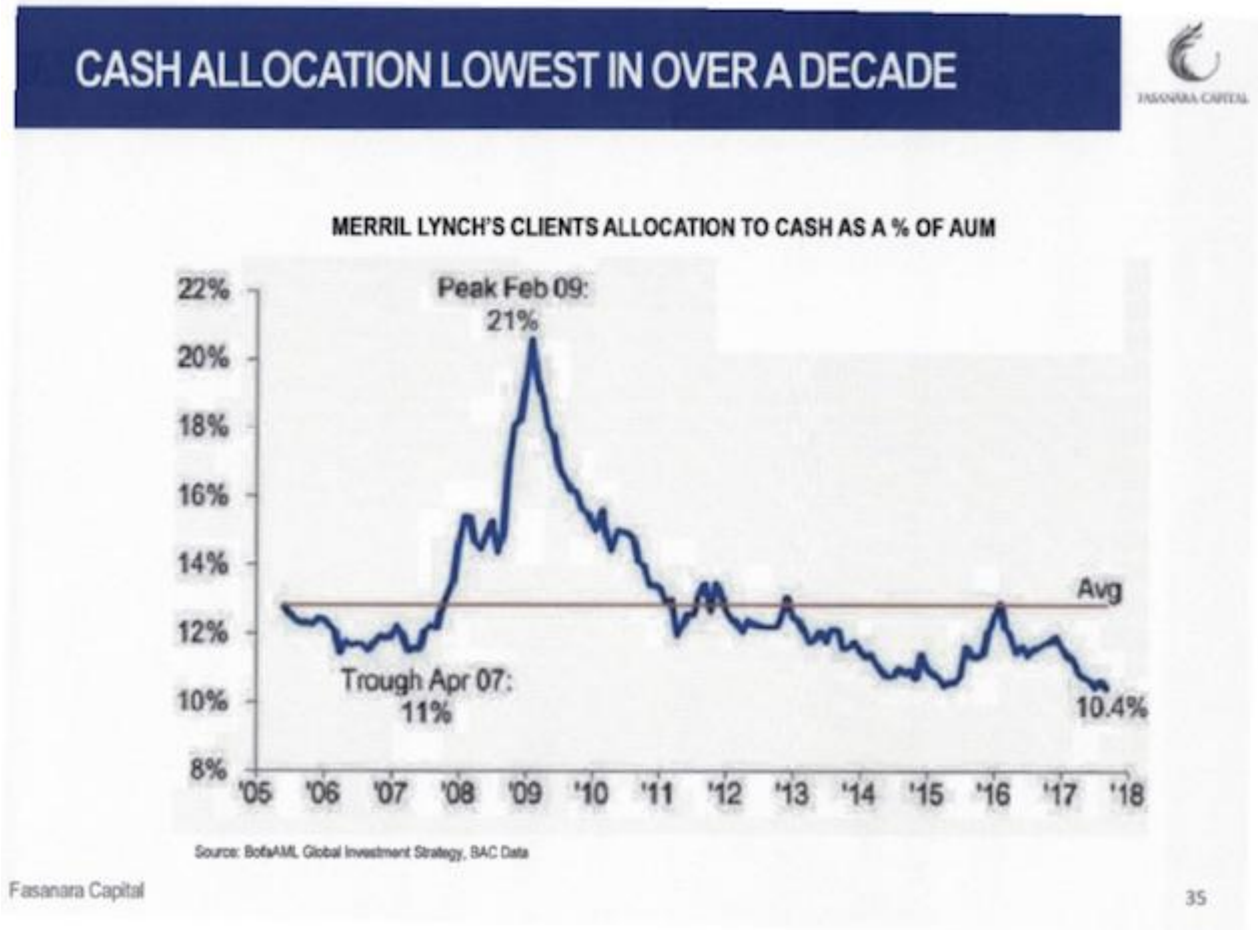
Now, the usual economic pundits tell us that the situation is safe and under control and that we all have plenty of cash and cash flow to be able to handle this load of debt. Worrying about debt is so 1900s, they say. And they may have a point, in that many of us are able to use debt in responsible ways. But how about that $1.2 trillion in student debt?

While lending has been a very lucrative business in recent decades, it's hard to believe it can last. At some point we must experience a great deleveraging. When that happens, it won't be fun.

Against the Crowd

"Contrarian" investors believe success lies in going against the crowd, because the crowd is usually wrong. That is often a very good assumption. My own experience suggests one small adjustment: Pay attention not to what the crowd *says* but to what it *does*. Words are cheap.

This next chart is a prime example. We see here the amount of cash held by Merrill Lynch clients from 2005 to the present, as a percentage of their assets. The average is about 13%.



Of course, people hold cash for all kinds of reasons that don't necessarily reflect their market outlook. Nor does this chart tell us how their non-cash assets were allocated. The pattern is nevertheless uncanny. In 2007, as stock indexes reached their peak, cash holdings were well below average. They rose quickly as the crisis unfolded, peaking almost exactly with the market low in early 2009.

In other words, at the very time when it would have been best to reduce cash and buy equities, Merrill Lynch clients did the opposite. And when they should have been raising cash, they kept their holdings low. I don't think this pattern is unique to Merrill Lynch's clients; I suspect we would see the same at most retail brokerages. Market timing is hard for everyone.

The disturbing part is where the chart ends. Merrill Lynch client cash allocations are now even lower than they were at that 2007 trough. Interest rates are much lower, too, so maybe that's not surprising. Central banks spent the last decade all but forcing investors to buy risk assets and shun cash. This data suggests it worked. But whatever the reason, investor cash levels suggest that caution is quite unpopular right now. So if you consider yourself a contrarian, maybe it's time to raise some cash.

Michael Lewitt's latest letter came in this morning and then he helpfully contributed this list of absurdities:

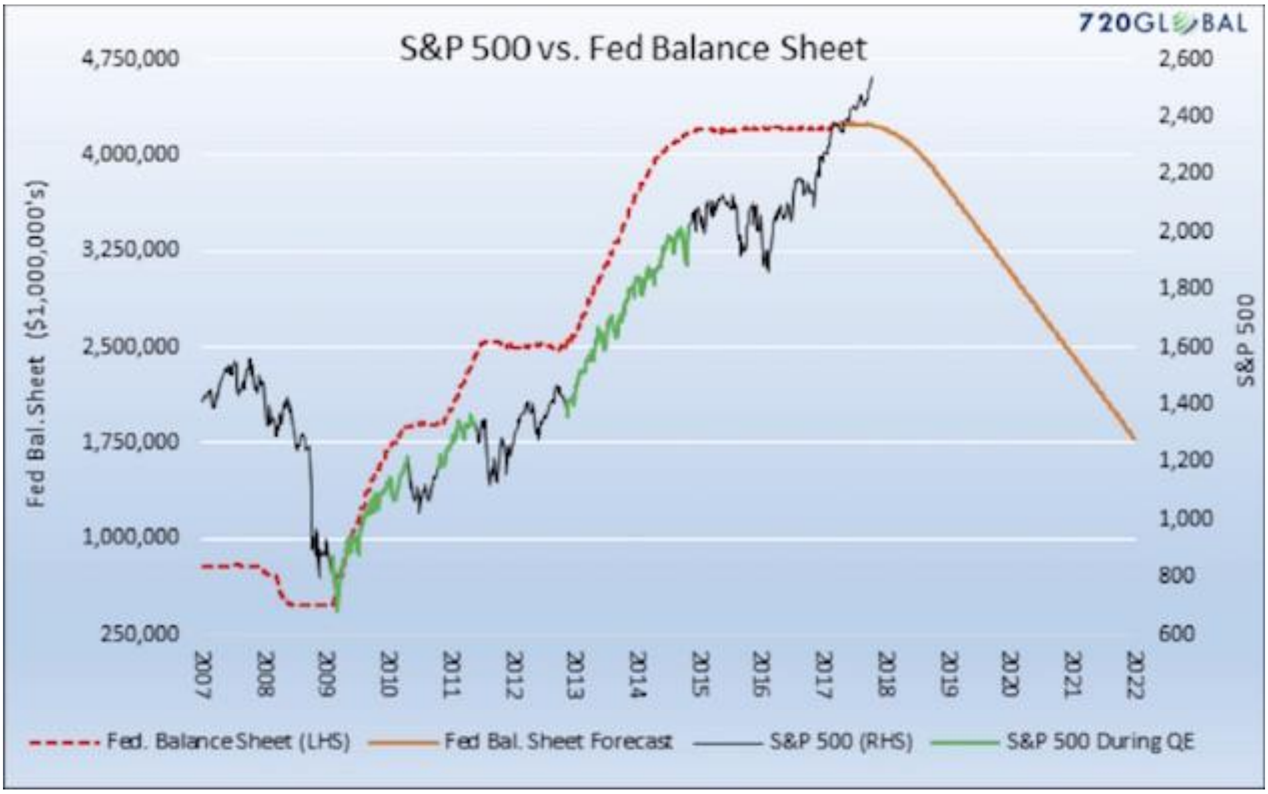
Anyone questioning whether financial markets are in a bubble should consider what we witnessed in 2017:

- A painting (which may be fake) sold for $450 million.
- Bitcoin (which may be worthless) soared nearly 700% from $952 to ~$8000.
- The Bank of Japan and the European Central Bank bought $2 trillion of assets.
- Global debt rose above $225 trillion to more than 324% of global GDP.
- US corporations sold a record $1.75 trillion in bonds.
- European high-yield bonds traded at a yield under 2%.
- Argentina, a serial defaulter, sold 100-year bonds in an oversubscribed offer.
- Illinois, hopelessly insolvent, sold 3.75% bonds to bondholders fighting for allocations.
- Global stock market capitalization skyrocketed by $15 trillion to over $85 trillion and a record 113% of global GDP.
- The market cap of the FANGs increased by more than $1 trillion.
- S&P 500 volatility dropped to 50-year lows and Treasury volatility to 30-year lows.
- Money-losing Tesla Inc. sold 5% bonds with no covenants as it burned $4+ billion in cash and produced very few cars.

This is a joyless bubble, however. It is accompanied by political divisiveness and social turmoil as the mainstream media hectors the populace with fake news. Immoral behaviour that was tolerated for years is finally called to account while a few brave journalists fight against establishment forces to reveal deep corruption at the core of our government (yes, I am speaking of Uranium One and the Obama Justice Department). In 2018, a lot of chickens are going to come home to roost in Washington, D.C., on Wall Street, and in the media centers of New York City and Los Angeles. Icons will be blasted into dust as the tides of cheap money, cronyism, complicity, and stupidity recede. Beware entities with too much debt, too much secrecy, too much hype. Beware false idols. Every bubble destroys its idols, and so shall this one.

Liquidity Lost

The next absurdity is absurd because it is so obvious, yet many don't want to see it. Too bad, because I'm going to make you look. This comes from Michael Lebowitz of 720 Global. It's the S&P 500 Index overlaid with the Federal Reserve's balance sheet and the forecast of where the Federal Reserve intends to take its balance sheet.



As I noted above, the Fed and other central banks have practically forced investors into risk assets since 2008. You can see the relationship very clearly in this chart. The green segments of the S&P 500's rise occurred during quantitative easing programs. Correlation isn't causation, but I think we can safely draw some connections here.

Ample low-cost liquidity drives asset prices higher. That's not controversial. It makes perfect sense that the *withdrawal* of ample low-cost liquidity would also impact asset prices in the opposite direction.

The Fed has even given us a schedule by which it will unwind its balance sheet. Michael's chart gives us a sense of how far the S&P 500 could drop if the Fed unwinds as planned and if the relationship between liquidity and stock prices persists. Either or both of those could change; but if they don't, the S&P 500 could fall 50% in the next few years.

At the risk of repeating myself, I think it is borderline dysfunctional for the Fed to be raising interest rates and at the same time experimenting with reducing its balance sheet. Where's the fire? Seriously, we waited for four years, deep into the recovery, before the Fed found enough intestinal fortitude to begin to timidly raise rates. And now they think they have to proceed at warp speed? I just don't see this ending well.

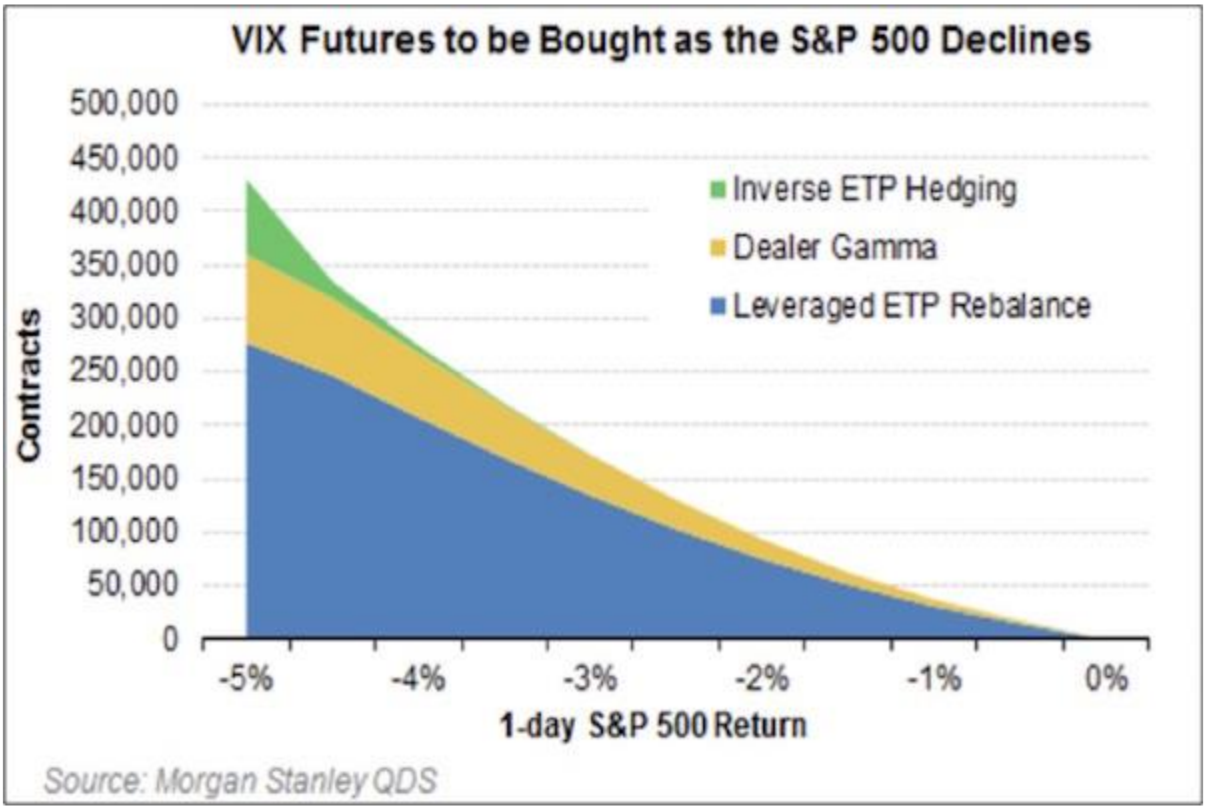
What would be really absurd, I submit, would be to see this data and then somehow convince yourself that stock prices can keep climbing or even merely hold steady as the prime mover that drove them higher moves in the opposite direction.

Mobbing the Exits

Another peculiar wrinkle in the situation today is that many investors see all these warning signs but think they can keep riding the market higher and hedge against losses at the same time. It doesn't really work that way. However, it's easy to see why people think they can get away with it. Wall Street firms have rolled out all kinds of volatility-linked products that purport to protect you from sudden downside events.

In various ways, most of these products are linked to the Volatility Index, or VIX. Volatility has been persistently low as the market has risen in recent years. That has made it cheap to buy protection against a volatility spike. However, it's not clear if the sellers of this protection will be able to deliver as promised.

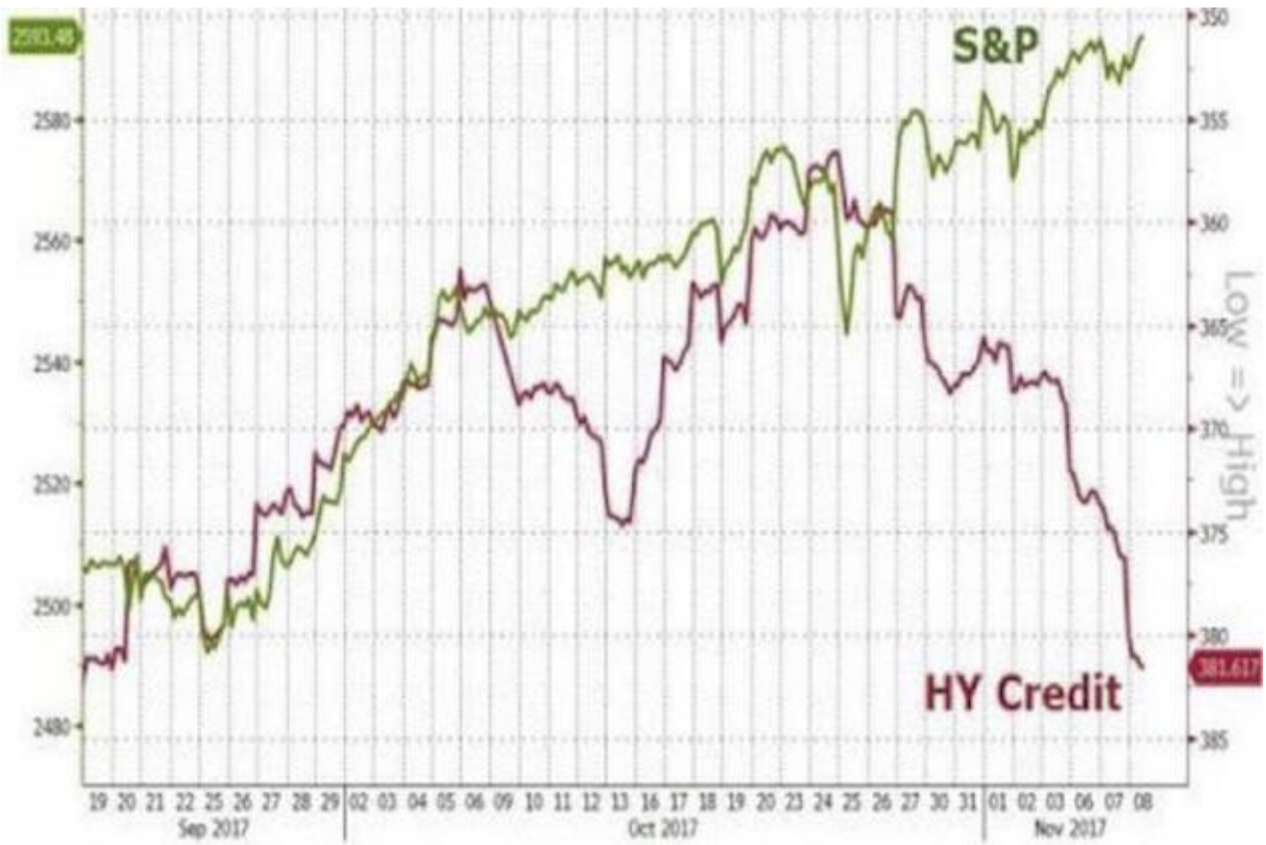
My friend Doug Kass has been concerned about this for some time. He believes the risks of a "flash crash" are rising, and those who think they are hedged may learn that they are not. He shared this Morgan Stanley graphic of how many VIX futures contracts would have to be bought to cover a one-day market drop.



Between hedgers, dealers, and ETP sponsors, a one-day 5% downward spike in the S&P 500 would force the purchase of over 400,000 VIX futures contracts. This was in October, and the figure has probably risen more since then. Doug isn't sure a market under that kind of stress can deliver that much liquidity.

Every market downturn seems to expose the vacuity of some new, sophisticated hedging product. In 1987 it was "portfolio insurance." Whatever the particulars, the schemes all purport to let investors ride the market higher without taking on meaningful downside risk. That is not how hedging works. I suspect the various VIX-linked products will disappoint buyers when the unwind occurs.

Doug also shared what will be the final graph for this week and observed, "This is the dreaded alligator formation, and the jaws always close." It's just a matter of time. It could take another year and get even sillier, but when that gator snaps its jaws shut, a lot of people will get bitten. I personally think the bubble in high-yield debt, accompanied by so much covenant-lite offerings, will be the source of the next true liquidity crisis.



The amount of money available to market makers to use to maintain some type of order in a falling high-yield market is absurdly low. Investors in high-yield mutual funds and ETFs think they have liquidity, but the managers of those funds will be forced to sell into a market where there is no price and there are no bids. Oh, the bids will show up at 50% discounts. Distressed-debt funds and vulture capital will see opportunities, and they will be there. Talk about blood in the streets.