The Investor©
In our 31st year of service to the South African public!

Lessons for a new President

By Richard Cluver

In his inaugural State of the Nation address to Parliament, our new President Cyril Ramaphosa won the hearts and minds of a majority of South Africans with his commitment to new beginnings, a promise to be a "Servant of the People" and to work towards the common good of all.

Impartial students of history might, however, lament his underscoring the importance of two major issues that have been embraced by ANC policymakers but which experience has shown will almost certainly be to the long-term detriment of the economy as a whole, and as a consequence, will NOT benefit the majority of the people.

With unemployment levels higher than they have ever been in the history of our country, the most pressing need is to embrace policies that will create jobs and anything that gets in the way of that objective should be firmly rejected. To that end the Government needs to foster foreign investment and NOTHING is more likely to chase away investors than a policy that undermines the sanctity of property ownership. Even a whisper that the ANC might seek to change the Constitution to facilitate their seizing privately-owned property without compensation will guarantee that entrepreneurial foreign investors will stay away just as it has already accelerated the emigration of privately-owned capital.

Furthermore, detailed studies have shown that there is already sufficient land in Government hands to satisfy the legitimate needs of everyone who has been historically deprived. The real need is to assist with money and expert guidance those who would seek to farm such land as is already in State hands.

President Ramaphosa also hailed as a triumph the fact that from May this year the ANC's efforts to install a national minimum wage will become a fact and he saw this as a potential major upliftment for the poor. While the principle is probably sound given the vast inequalities that currently exist, the danger is that it will be used by politicians to gain points at the polls to the long-term detriment of the economy and the very people that it seeks to benefit. And of course it will be detrimental to the cause of job-creation.

No better example of this threat could be found than by an examination of how the minimum wage concept has been exploited by successive Australian governments to effectively destroy that country's export industry as well as vast swathes of domestic industry. Australia and New Zealand lay claim to the introduction of the concept of minimum wages which were first introduced there as far back as 1896 and which became the model for its introduction in Britain in 1909 and in many other countries subsequently. However, since 2005 with the establishment of the Australian Fair Pay Commission, the concept has moved so far out of line with sound economic planning as to become the reason why vast swathes of Australian business are today in stagnation and why thousands are out of work. The rising rate of Australian unemployment and the prevalence of youth unemployment are today such pressing issues as to threaten the future of the main political parties.

Recently, the rate of full-time jobseekers in the 15 to 19 year-old age group has risen to 25.5 percent, a rate very comparable with South Africa's. Simply stated, minimum wage rates have made it all but impossible for small businesses to take on new staff. Furthermore, since young people are entitled to unemployment pay of $501.00 per fortnight for single people, or $452.30 each for a couple this has become a compelling reason why Australia's young choose to "live in sin".

Converted at ten Rands to the Australian dollar, those figures represent a monthly dole for Australian youth of R10 855; the reason why many could not be bothered to seek work and an important factor to explain why Australia has one of the worst youth drug addiction problems in the modern world.

Currently, Australia's minimum wage is $18.29 an hour and will shortly rise to $22.20 an hour which, by the same conversion and assuming an eight-hour working day equals R461 760 a year or R38 480 a month.

New Zealand is often a mirror of Australia but it is nowhere near them in the quantum of minimum wages with a current figure of $15.75 per hour for employees aged 16 years or older. That translates to R27 000 a month. That is still high by South African standards, and particularly in respect of their main food export destinations in the Far East. The result is that New Zealand is still a major exporter of lamb, butter and wine whereas Australia has lost most of these export markets and has been obliged to close many of its major manufacturing plants. Thus, for example, Australia has in the past year closed the last of its once booming car manufacturing plants and now has to rely upon imported vehicles. Thus it is forced to rely upon its mineral wealth and mining industries which are, of course, being squeezed between, until recently, falling international prices and rising domestic wages.

Again, to illustrate the point, the best red wine I bought last year was a Cabernet from Lust and Vrede in Stellenbosch at a price of R130 a bottle. Over the Christmas period I tasted wine extensively throughout Australia's three main wine growing areas and did not once taste the like of good South African reds... However I tasted several nearly as good at $150 a bottle. When I protested that I could buy wines from the most famous "First Growth" French wine estates for less, I received a rueful nod and confirmation that Australian production costs had destroyed their export markets.

In the January issue of ***The Investor*** I dealt with another major issue that the ANC needs to deal with if it hopes to attract serious long-term investors; that of the unfair taxation of investors. Again Australia has shown us the way and this is arguably the second greatest threat to their economy. In order to fund the ever-rising costs of its dole system, Australia had just introduced Capital Gains Taxation when I was in Australia 20 years ago as a speaker at an investment conference in Sydney.

As a sop to the electorate they allowed that their citizens would NOT be taxed on the increase in value of any EXISTING assets. And this has come back to bite them in a very big way. It is most evident in Australian house prices where, for example an average house in Sydney now fetches between $3 and $6-million and believe me, by South African standards, you do not get a whole lot for $6-million. (That is over R60-million at the current exchange rate – enough to buy the best Cape Town has to offer foreign millionaires)

Root cause of the problem is capital gains taxation on people's homes. Since it is NOT levied on homes bought before the introduction of the tax, elderly folk who have seen their families grow up and leave home, are not prepared to sell, particularly since the consequence has been a massive housing shortage which has led to the consequent rapid increase in house prices. They have been content to let out their homes at rentals they could never in their wildest dreams have imagined receiving 20 years ago. Letting allows ageing owners to live very good lives elsewhere in cheaper residential areas far from the main cities but does nothing to satisfy the needs of young families nor those of well-heeled immigrants who have been pouring in from land-starved locations like Hong Kong and Singapore.

Meanwhile, those with no option but to pay these massively-inflated prices are sitting on a potential time bomb for, as world interest rates have begun trending upwards, the costs of their mortgages are becoming increasingly unaffordable.

It is not difficult to imagine in Australia a repeat of the Great Depression scenario when home owners moved out of their houses and took to the roads when they were no longer able to meet mortgage costs when, in any event the consequent collapse of house prices meant that their indebtedness far outweighed the value of their homes. So in the late 1920s they simply posted the front door key to the bank and their cars became their homes!

Readers will, furthermore, recall my article in last month's issue of ***The Investor*** in which I outlined the serious damage that Capital Gains taxation has wrought upon South Africans who have saved diligently towards an old age in which they should not be a burden upon either their children of the State and who are now effectively prevented from taking defensive action in the face of the probability of a share market crash sometime in the not too distant future.

Meanwhile, in passing I should point out that the proposed changes to South African expropriation law makes no specific reference to land. If the proposal were to pass into law there would, as things now stand, be nothing to prevent the Government from confiscating the ordinary assets of South African citizens; like their pensions, share portfolios, art collections etc etc. Once you open the flood gates there is no telling what greedy bureaucrats might not deem they need "in the public interest."

Just saying!

What has all the fuss been about?

By John Wyn-Evans

An investor lucky enough to be cut off from financial news so far this year might inspect their portfolio today and wonder what all the fuss has been about. The MSCI All Countries World Index (in US dollars) is up almost 2% since the end of last year.

Of course, those of us who have lived every minute of it will know that it was up more than 7% at its peak towards the end of January, and then fell 9% in little more than a week before recovering. Sterling based investors have struggled a bit more thanks to the pound's 3.6% rise against the dollar, although it should be noted that this is more a function of dollar weakness than sterling strength.

Thanks in part to this currency headwind, the UK's FTSE 100 Index is notable for being this year's worst-performing main stock market index when measured in local currency terms, having fallen 5.2% (China's Shenzhen Composite Index is down 8.43%, but is a more regional index stuffed with speculative technology stocks). Big steady overseas earners such as BAT, Royal Dutch Shell, BP, Diageo and Unilever dominate contributions to the near 400 points that the FTSE 100 has lost this year. But it must be said that there are also a few names on the list of poor performers where the losses have been more to do with the market's reaction to company-specific news, and these include Vodafone, Shire and Imperial Brands.

Interestingly, several companies that generate a small part (or even none) of their revenue in the UK are amongst the biggest positive contributors to the index's performance. Within the Top 10 are Anglo American, Rio Tinto, WPP, Standard Chartered and BHP Billiton. The strong nature of global growth is seen as supportive for mining companies, and the potential for higher interest rates is positive for banks' earnings.

These large companies tend to make regular appearances in the big contributors to index movements owing to their high share of market capitalisation, so it's also useful to look at the best and worst performers regardless of size. There is no consistent theme apparent amongst the winners, with GKN topping the list following the bid approach from Melrose. Companies such as EasyJet and Just Eat have benefitted from strong trading updates. Next defied the gloomier prognostications for all things retail. Old Mutual’s South African business became more valuable once Jacob Zuma had resigned as president.

At the other end of the table there are several companies that have encountered specific business difficulties, and these include Standard Life Aberdeen, BT Group and Micro Focus. However, there is a more dominant macro theme at play amongst the losers, and that is the threat from higher interest rates and bond yields. Housebuilder Barratt Developments, real estate company Hammerson, and utilities Severn Trent and United Utilities are all in the bottom ten.

As a firm we are committed to active stock-picking and asset allocation. Yes, there are periods when index investing will deliver easier, more consistent returns, but often at the expense of investors herding into popular shares, creating greater risk for the future. Whether it be picking individual securities or in our choice of third party fund managers, we definitely believe it is worthwhile making the effort, and, indeed, taking the risk to enhance longer-term returns for clients.

Although equities tend to dominate the headlines, developments in bond markets often lead the performance of other asset classes. Bond markets have suffered more sustained losses this year. The US 10-year Treasury yield has risen from 2.4% to 2.87%, which will have delivered a near 5% capital loss to holders. The UK 10-year Gilt yield has also risen sharply, from 1.19% to 1.6%. However, it is notable that the FTSE Actuaries UK Conventional Gilt Total Return Index has “only” lost 2.5% so far in 2018, despite having an average duration of about 11 ½ years. The rise in yields has been much greater in the 5-10 year maturity range, with, for example, the 30-year Gilt yield rising only 20 basis points. The longer end of the yield curve tends to be supported by persistent regulator-driven demand from pension funds and insurance companies, but could also reflect the fact that the current inflation scare is more a short-term cyclical fear than a long-term structural one.

The market-derived expectation for UK inflation in ten years’ time has risen only marginally from 3.05% to 3.15% this year.

Even at its lowest point last year in June it was still 2.93%. The big jump in inflation expectations came after the Brexit referendum, when the 10-year breakeven rate jumped from 2.3% to 3.1%. This was mainly down to the fall in the pound, but also reflected more structural Brexit fears, such as a tighter jobs market in the absence of free movement of labour from the Continent, as well as more costs associated with cross-border trade.

Inflation expectations are broadly unchanged since the summer of 2016. The picture in the US is different. There has been a greater acceleration of inflation expectations since mid-2017, with the 10-year breakeven rate rising from below 1.4% last June to 2.1% now. Some of that is down to the dollar's reversal, some to the washing out of lower oil prices and mobile phone contract offers, but there is a much greater sense of late-cycle boom conditions than elsewhere, amplified by President Trump's big deficit-funded tax give-away.

It is very much the sentiment in US bond markets, and thus the focus on inflation and deficit-spending, that is setting the tone for all other markets right now. Next week, barring any other excitement developing, I will delve deeper into the inflation debate.

**John Wyn-Evans is Head of Investment Strategy at Investec Wealth & Investment UK. The Weekly Digest is an Investec Wealth & Investment UK publication*

The Stock Market Isn't the Economy. Here's How They Can Shape Each Other

By Matt Phillips and Troy Griggs writing in the New York Timers

Stock markets have recently fallen over fears that economic growth is too strong. Here's why, and one way how steep, sustained sell-offs could end up hurting the economy.

Recently stock markets slipped, plummeted, recovered, whipsawed and plummeted again — as investors fret about the state of economic growth. Specifically, investors may be worried that growth is ***too*** strong.

This might seem like a strange concern, after a decade of slow-but-steady economic expansion coming out of the recession.

But global growth — along with a shred of evidence that Americans are starting to get wage increases — started a broad sell-off that spread around the world. Since then, prices have been all over the place.

Why?

Here's how the logic goes:

• The strong economy stokes **fears that inflation is picking up**.

• Fears about inflation drive worries the Federal Reserve could **raise interest rates faster** than indicated.

• The worries about the Fed fuel a long-held view that **rising rates kill bull markets**, partly because companies tend to grow more slowly when money becomes more expensive to borrow.

• That daisy chain of anxiety lead to **a simple conclusion: Sell**.

This may not be why investors may be panicky. Markets can be driven by perception as much as anything else, and the spectre of the status quo being disrupted can rattle investors. Even the president, who has often boasted about the stock market's rise under his watch, has noted how the response seems irrational.

In a different moment, financial markets could well have greeted data on rising wages with huzzahs. Fatter pay checks can put more money in the pockets of shoppers, and potentially increase profits for companies riding the economic wave.

But for the moment, markets have been plagued by volatility, and how long it moves in financial markets can ultimately affect the economy — especially if they persist.

Here’s one way how:

• Steep market **declines can wipe out portions of people’s savings** and retirement accounts.

• **Bond yields can rise** as investors demand higher returns to stay ahead of inflation.

• Higher yields translate into **higher borrowing costs** for companies and individuals.

• And with higher borrowing costs, companies invest less in their business and **people buy fewer things**.

• Less spending and investment **undermines economic growth**.

Earlier this month both the Standard & Poor’s 500-stock index and the Dow Jones industrial average entered into a correction, meaning they have fallen by 10 percent since their peak. It’s a signal that more down days could come. But for now, the declines have only spanned a week, and it’s still too soon to tell whether stocks are destined for a so-called bear market.

“My outlook hasn’t changed just because the stock market is a little bit lower than it was a few days ago,” William C. Dudley, president of the New York Fed, said on Wednesday. “If the stock market were to go down precipitously and stay down, then that would actually feed into the economic outlook.”

Lessons from US tax reforms

by Brian Kantor

Reducing the US corporate tax rate and the taxes applied to offshore profits earned by US corporations and the repatriation of cash generated offshore, has had perhaps unintended consequences that are proving very helpful to the tax reformers. Some leading companies have immediately converted lower taxes to bonuses for their employees.

These reactions help raise the issue of who actually pays an income tax or a payroll tax. Those employees soon to notice a lower tax charge on their salary slips will have no doubts about who pays the income tax – and how they benefit from any reduction in tax rates. Shareholders receiving extra dividends, because the company has more after tax cash to distribute, will draw similar conclusions about the immediate benefits of lower tax rates.

But these immediate reactions to lower tax rates in the US will not be the last or the most important consequences of lower income tax rates. Lower tax rates will have improved the prospective returns on capital invested by US companies. More than pay dividends or buy back shares, the company may therefore wish to invest more in plant and equipment.

If so, and this seems very likely judged by the reactions of CEOs, the additional capacity will give these firms the capacity to produce more. To sell more they may well have to reduce prices or improve the other terms on which they supply their customers. The benefits of lower tax rates will thus also go to their customers in the form of lower prices or better quality or better service, depending on the competition to attract more custom. And workers may benefit as the firm hires more of them, perhaps on more favourable terms, again depending on the competition in the labour market for new hires.

In the long run the benefits of a higher return on shareholders capital, higher because less is paid away in taxes, will tend to be competed away. Actual returns after taxes may then fall away to a new equilibrium of lower required returns on a larger stock of equipment and a larger, better paid labour force in which more intellectual capital has been embedded. The effects of higher tax rates would similarly be reversed into higher prices as investment and hiring activity responds negatively to higher required returns before taxes.

These long run effects will be hard to identify, precisely because nothing much of what else will affect the economy will remain unchanged after a tax regime is changed and economic actors respond. Exchange rates may change, while tax rates in other countries may change to make imports more competitive. Trade across borders may be become more or less open. Yet it would be hard to argue that changes in taxes will not have wider consequences than is revealed on a payslip or dividend payment.

It is also surely true that the benefits, medical or pension etc. that employers provide for their workers will influence the supply of workers, skilled and unskilled, to the firm. The better the benefits, the greater will be the potential supply of job applicants and the lower the quit rates. Increased supplies of actual and potential workers in response to improved other benefits of employment will mean the firm has to offer less take home pay to attract the workers it wishes to hire.

Employees may well be paying for the benefits in the form of a cash salary sacrifice, which is to the advantage of the hiring firm. And taxpayers will be contributing, should the benefits in kind rather than cash enjoy much lower tax rates, in other forms of tax. Such tax favours for employees may help make the firm more competitive, in the form of a lower wage bill. This in turn may enable it to offer lower prices or better terms to their customers – as in the case of lower income taxes. In these and many other ways, hard to identify, taxes tend to find their way into the prices consumers pay for the goods and services they buy. And this applies to all taxes and not only the VAT or sales taxes imposed on final expenditures.

Higher taxes mean higher prices and vice versa. And as important for the supply side effects of taxes of all kinds is how well the tax revenues are utilised. A good ratio between taxes collected and benefits provided, for obvious example in the quality of education supplied by governments, will tend to increase the supply of skills and lower costs of production and prices to the benefit of consumers ultimately.

The conclusion to come to when recognising the full ramifications of a tax system on the supply of and demand for goods and services, is to keep the tax system as simple as possible. That is to avoid trying to redistribute income through taxes of one kind or another (that find their way into prices) and hence may not redistribute income at all. All taxes may become a tax on expenditure rather than on income. Appearances of redistribution of income through can be very deceptive and damaging to an economy.

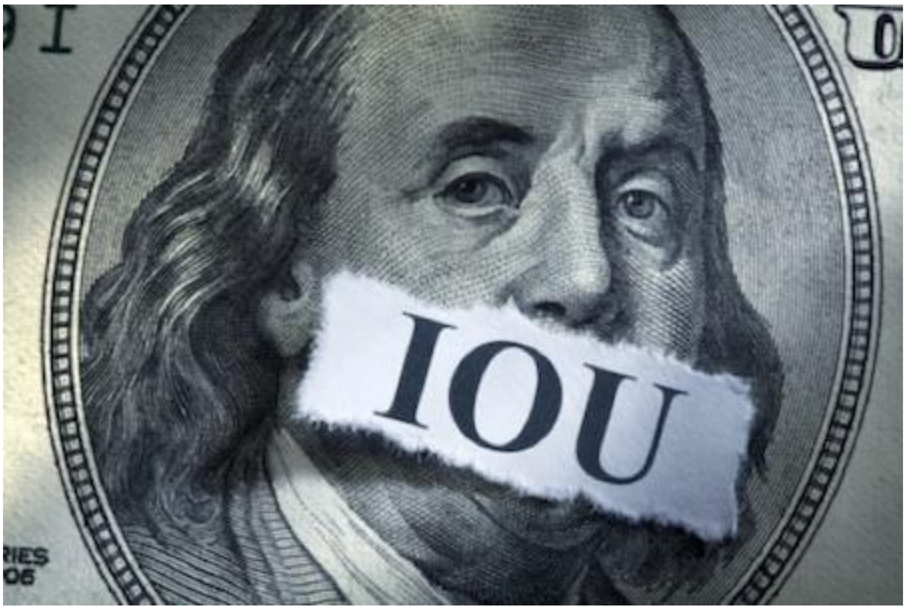
It would be more helpful to recognise reality and simply tax expenditure of all kinds at the same rate, thus avoiding income taxes, including taxes on income of companies and taxing one form of income in cash or kind at very different rates. Redistribution is best done by targeting government expenditure – not taxes. As is raising the taxes to pay for benefits as least disruptively as possible.

Where will we get the cash?

By John Mauldin

Last week's turbulence shined a harsh spotlight on the stock market. Appropriately so, if that's where your investments are. But in the hubbub many investors are missing the deeper and far more urgent bond market issues.

We already knew interest rates were rising. Recent data suggests they could rise significantly more than many expected just a few weeks ago. If so, that will be a big problem for bonds, stocks, and many other assets – not to mention taxpayers who will bear the cost of swelling government debt, consumers who may face inflation, and everybody who will be hurt by a recession.



Getty Images

The combination of a falling stock market and rising interest rates is historically and statistically rare. Normally, when the stock market goes through a correction, interest rates fall. Looking back through history, we see that 1987 and 1994, two years I have been writing about in connection with 2018, were the other unusual years.

I've been relatively optimistic on the economy this year, and I still think the year can end well. But given recent events, the path is more challenging now – and the odds of a rough 2019 are growing.

Burn Rate

Sudden market moves usually have many contributing factors, but they still need a trigger. Typically, it's some new piece of information that wasn't already reflected in prices. What did we learn just ahead of the drop on February 2 and then the bigger one on February 5?

I still think the key factor was the Friday unemployment report, which showed wage growth of 2.9%. It has been a long time since we've approached 3% wage growth. The markets, probably rightly, interpreted this as a sign that the Fed will turn more hawkish if that trend continues. The Fed going into inflation-fighting mode is not bullish for the market. From a recent Congressional Budget Office (CBO) statement:

> Next, because the tax legislation reduced individual income taxes for most taxpayers, the Internal Revenue Service released new income tax withholding tables for employers to use beginning no later than the middle of February 2018. As a result of those changes, CBO now estimates that, starting in February, withheld amounts of individual income taxes will be roughly $10 billion to $15 billion per month less than anticipated before the new law was enacted. Consequently, withheld receipts are expected to be less than the amounts paid in the comparable period last year. In addition, the government ran a deficit of $23 billion in December, and it normally runs a deficit in the second quarter of the fiscal year.

We knew part of this. The tax bill President Trump signed in December was passed under reconciliation rules that allowed the reduction of revenue by $1.5 trillion over 10 years. That works out to $12.5 billion per month, roughly the amount CBO says tax withholding will drop. Economic growth is supposed to offset this. I think it will to some extent, but not enough and, more importantly, not ***soon*** enough.

Also on Friday, in a separate report, the Treasury Department estimated that it will borrow $955 billion in FY 2018. That estimate is based on input from a group of private banks that advise the Treasury. If the amount is correct (and it may not be), it will represent an 84% increase over the $519 billion Treasury borrowed for FY 2017. This huge increase is clearly not taking us in the right direction, and it's more than can be accounted for by lower tax revenues. Nor is it a one-time blip. The same report forecasts borrowing of $1.083T in FY 2019 and $1.128T in FY 2020.

The budget that has now been passed by the Senate and is likely to pass the House and be sent to Trump to be signed will add another $300 billion to the deficit over just the next two years. We are going to exceed $1.2 trillion in average debt for the next three years, and that's just the on-balance-sheet deficit.

What's the problem, you ask?

The answer will get us into some little-examined and perhaps arcane fiscal policy issues. They are nevertheless important. In short, the ***budget deficit*** and the ***amount of government borrowing (for the year)*** are two different things. The official deficit increasingly understates the problem… and I think markets are starting to realize that.

Getty Images

Politicians like to talk about managing the federal budget the way you manage a family budget. This rhetoric makes for good sound bites but ignores an obvious reality: The federal government isn't like your family. It has exponentially greater powers and responsibilities and is a sprawling behemoth to boot. The same budgetary principles don't always apply.

For one, you can't set your home budget and then add additional expenses without changing your budget parameters. The government can do so, and it does. These are the so-called "off-budget expenditures" you may have heard about. They don't affect the official deficit that is discussed in the press. They do affect the amount of cash the government needs. Where does it get that cash? It borrows it by issuing Treasury paper.

Off-budget expenditures pay for a variety of programs: Social Security, the US Postal Service, and Fannie Mae and Freddie Mac are among the more familiar ones. But the category also includes things like disaster relief spending, some military spending, and unfunded liabilities that turn into actual costs. Federal student loan guarantees sometimes force the government to disburse cash. That's an off-budget outlay.

Off-budget outlays have risen in part because they include Social Security benefits, and the Baby Boomer generation is retiring. But the other categories mentioned above have grown as well, and they are increasingly problematic.

The Treasury Department has the unwelcome job of juggling the government's cash flows to pay the people and businesses Congress has decided should be paid. When there isn't enough tax revenue, Treasury must borrow to meet the difference. Any unforeseen decrease in tax revenue or increase in expenses can force it to borrow more. This activity has nothing to do with the formal "budget" even when we have one, and we currently don't.

Do you remember a headline mentioning annual trillion-dollar increases in the US debt during the last eight years of the Obama administration? I didn't think so.

The problem has been papered over by off-budget receipts, mainly Social Security taxes, that give the US Treasury more cash it can disburse. But eventually the benefits those taxes represent come due. Then outlays go up, but revenue may not. We are rapidly reaching that point. Look at this table, which I found here and excerpted:

National Debt by Year: Compared to Nominal GDP and Major Events

End of Fiscal Year	Debt (as of 9/30, in billions)	Debt/ GDP Ratio	Major Events by Presidential Term
2008	$10,025	67%	Katrina cost $24.7 billion. ARRA added $241.9 billion to FY09 budget.
2009	$11,910 ($11,000 on Mar 16 and $12,000 on Nov 16.	83%	
2010	$13,562 ($13,000 on Jun 1 and $14,000 on Dec 31.	90%	Obama Stimulus Act cost $400 billion. Payroll tax holiday ended. War cost $512.6 billion. Great Recession and tax cuts reduced revenue.
2011	$14,790 ($15,000 on Nov 15)	95%	
2012	$16,066 ($16,000 on Aug 31)	99%	
2013	$16,738 ($17,000 on Oct 17)	100%	
2014	$17,824 ($18,000 on Dec 15)	102%	War cost $309 billion. QE ended. Str dollar hurt exports.
2015	$18,151	101%	
2016	$19,573 ($19,000 on Jan 29)	105%	
2017	$20,245 ($20,000 on Sept. 8, 2017.)	104%	Congress raised debt ceiling.

You will notice that there are many years during which the US debt rose by more than $1 trillion. Note that 2015 saw an increase of $1.4 trillion, while the on-budget deficit that year was "just" $439 billion.

Admittedly, 2015 was an outlier, but lately it hasn't been much of one. Look at this chart of the on-budget deficit for the last 10 years. Comparing to the above table, you can see that off-budget deficits have been running more than $500 billion recently. Some years not so much, but the general trend has been from the lower left to the upper right.

Here is the federal deficit by year for the last decade:

Deficits in billions										
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
$161	$458	$1,413	$1,294	$1,295	$1,087	$679	$485	$438	$585	$666

But wait, there's more.

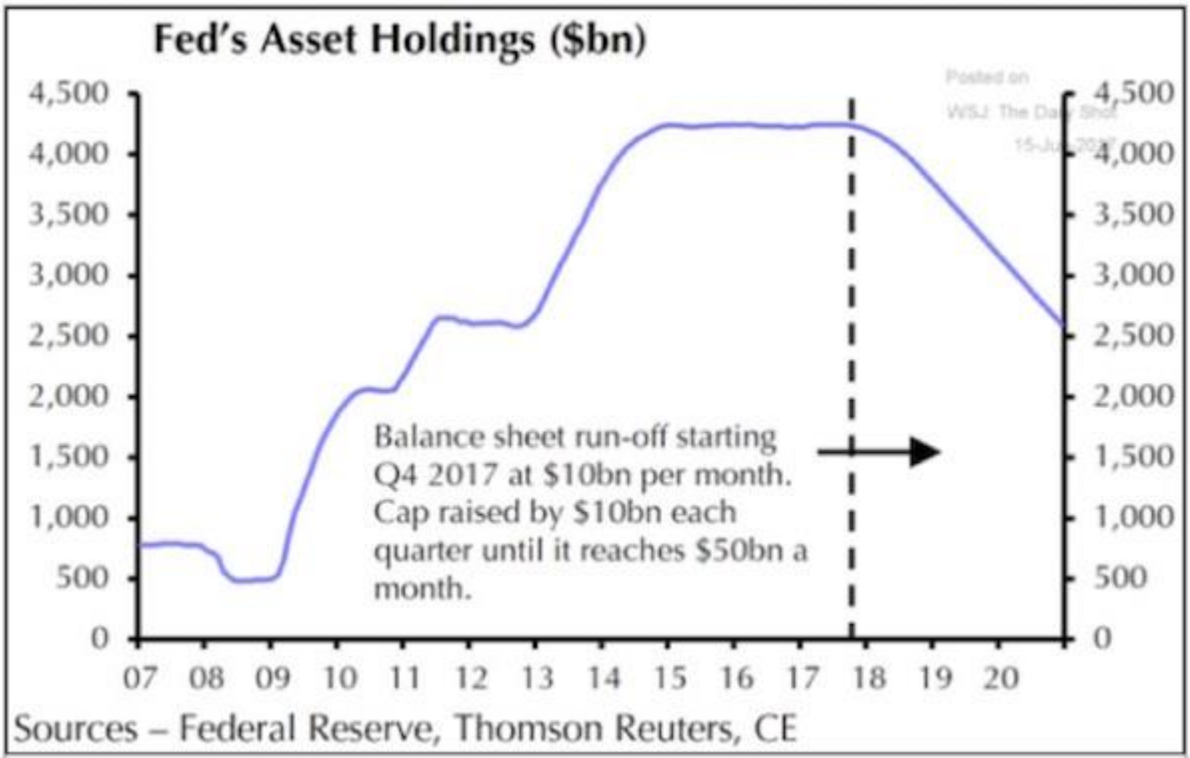
0% Financing Ends

Since 2008 the Federal Reserve has greatly simplified Treasury's cash management task. It has kept short-term rates ultra-low, allowing the Treasury to borrow tons of cash with minimal financing costs. The Fed also bought Treasury bonds directly as part of its quantitative easing programs. Since the Fed sends most of the interest it receives right back to the Treasury, those bond purchases amounted to almost interest-free financing. The average interest paid on the US debt has been reduced to less than 2%, largely because Treasury has loaded up on short-term debt in order to reduce the interest-rate costs that must be allocated to the budget deficit each year. So rather than focusing on long-term debt with the 30-year at an all-time low, Treasury has been selling short-term bills and notes. That's good cash management in the short run and very short-sighted in the long run.

Both those factors are now changing. The Fed is actively raising short-term interest rates while also reducing its Treasury bond purchases. The FOMC's December "dot plot" suggests that rates will rise to 2.25% by the end of this year and to 2.75% in the longer term. This increase will raise Treasury's interest costs considerably. And the interest must itself be financed, so that requirement will drive borrowing needs yet higher. Do you think the chances are good that the Treasury will be able to finance its debt at 2% in 2019? Me neither. And with $20 trillion total debt, even a 0.5% interest rate increase will have an impact on the overall budget deficit.

Business Insider

On the balance sheet unwind, here again is a chart I shared last week:



Source: Capital Economics

The important point here is that the Federal Reserve balance sheet reductions are just now getting started. The pace will quicken. In January the Fed's Treasury bond assets dropped by $18 billion. The shrinkage will vary by month, but the combined total Treasury and mortgage bond balance is set to fall $420 billion this year and another $600 billion in 2019. The number will continue to fall at that pace until either the balance sheet reaches zero or the Fed decides to stop.

This path would be fine if the Treasury's cash needs were likewise falling. Instead, they are rising. That $1 trillion that the Fed is going to sell back to the market will cost the Treasury a minimum of 2% and probably closer to 2.5%. That increases the deficit by $20–$25 billion a year.

So let's add it up. The federal deficit will be north of $1.1 trillion. Let's assume the off-budget deficit actually drops to $400 billion and that the Federal Reserve is going to want to sell $460 billion into the market. (Note: some of that will be mortgages, and the rest will be US bonds and bills.)

Simple arithmetic suggests that we will need to find about $2 trillion in additional funding to buy government debt in 2018. And candidly, that may be an optimistic projection.

Which brings us to this letter's titular question: Where will we get the cash?

Lender Search

In theory, it should not be a problem for the US government to borrow all the cash it needs. Occasional political antics aside, we are the world's best credit risk. No one worries that they won't get their T-bond principal back. The entire global financial system depends on that rock-solid guarantee.

So, the question is less whether Treasury can repay than whether potential borrowers are healthy enough to supply our needs or might see better alternatives.

This question is important because Treasury is losing the Federal Reserve as a primary funding source. Who can take its place? There are several candidates. Unfortunately, each has barriers that may reduce their buying interest.

American savers and investors are prospects if they have money to lend. Unfortunately, the number who do is not growing. It may grow if unemployment stays low and wage growth accelerates, but the Baby Boomers are transitioning from savings mode to spending mode, so they won't help much.

US pension plans and other institutions that need to fund future obligations are natural Treasury buyers, too. Higher rates might entice back some buyers who have moved into corporate or other long-term bonds in the last decade. Then again, high enough rates will entice anyone back, but those higher rates come with a cost. Specifically, each 1% higher is $10 million per trillion dollars of debt issued. On our $22 trillion in total US debt (by the end of the year, give or take a few billion), that will eventually be about $220 billion in interest as rates go up and the debt has to be rolled over. That's interest per year!

That means we are spending approximately 15% of our revenue and 12% of actual expenditures just on interest.

There is also the issue of state and local pension funds, many of which have vast future obligations that are poorly funded and will likely remain so, given these entities' precarious financial condition. They should probably be buying more Treasury paper, but it's not clear that they can.

Getty Images

Other natural buyers are overseas. You hear a lot about China's owning so much of our government debt. It's true, but to some degree they have little choice. So long as the US runs a trade deficit with China and we insist on paying for our imports with dollars, China will probably continue to use those dollars to buy dollar assets with that export revenue. It can happen indirectly: Maybe China buys raw materials from Australia with the dollars, and then the Australians buy dollar assets. But in any case, the amounts are so vast that the Chinese gravitate toward the most liquid dollar asset –Treasury bonds.

China would like to convince its trade partners to deal in renminbi, and the partners are very slowly coming around. This is happening especially through China's gigantic

One Belt, One Road infrastructure initiative. The Asian and African nations where China is building ports, railroads, and other facilities are being "encouraged" to accept renminbi in payment and then use the currency to buy Chinese goods. But the simple fact of the matter is that a lot of the projects for One Belt, One Road require the spending of actual dollars.

That Chinese process is unfolding slowly. I don't worry about China's suddenly deciding to boycott US bonds. The Chinese don't presently have that choice. However, they firmly intend to reduce their dollar dependence wherever possible. I don't see them volunteering to lend us significantly more cash than they do now. And indeed, they have been reducing their dollar purchases – significantly.

OPEC is another once-reliable lender that is becoming less so. The reason isn't complicated. Growing US shale production reduces our need to buy oil from OPEC countries, in the Middle East and elsewhere. We are buying 7 million barrels per day of oil less from outside the US than we used to. If OPEC countries ship us less oil and gas, we ship them fewer dollars, and they lose capacity to buy our debt, even if they want to.

In fact, federal debt held by foreign investors rose from about $1 trillion in 2001 to around $6 trillion in 2013, but it has more or less gone sideways since that point. China and Japan are no longer buying large amounts of US debt. They're not selling it, either.

Look at it this way. I have a few fairly wealthy friends who are aggressive gold bugs. But when I ask them privately whether they are adding much to the actual physical gold they own, they say, "Not so much." Even though they are firmly convinced that gold is eventually going to $10–15,000, their appetite to increase their gold holdings seems to be sated.

In the same way, China and Japan and many other foreign countries seem to be saying, "We have enough US bonds; let's see if we can find some other way to spend our money."

Please note that Japan, Australia, and Europe all have initiatives to build infrastructure and to be part of the growth that is going to be happening along with One Belt, One Road. China is entirely comfortable with those moves, since that is money they don't have to spend – all they really need is the transportation infrastructure to move their products back and forth. They are perfectly willing to let Europe and Australia help build out Africa and Southern Asia.

And while the matter doesn't get much play, and the Trump White House doesn't seem to notice, the renminbi is actually quite strong. Chinese consumers are in the best shape they have been in for a long time, and they are using the strength of their currency to import goods, which typically have to be bought in dollars.

Further, many of the large state-owned enterprises have dollar-denominated debt that is essentially guaranteed by the Chinese government. Some of those dollars are going to come back to pay lenders, wherever they may be from.

You can go to this link to see how much each government around the world has actually invested in US Treasury securities. Interestingly, Ireland and the Cayman Islands are in third and fourth place behind China and Japan. At one point this past year, China actually had a little less in Treasury securities than Japan did, but they are both above $1 trillion total. The next four countries combined are up to $1 trillion+ total. And so on. You will also notice that many of the 10 largest holders are associated with major banking centres. And while their appetite is still rising, it is not growing by much.

Foreign buyers may represent another $400 billion available this year to purchase US Treasury securities. That still means we have to find at least $1.5 trillion from US sources. The smart money suggests that interest rates are going to have to go up in order to attract those buyers. That is one of the reasons we are seeing the very unusual circumstance of interest rates rising at the same time the stock market is falling out of bed.

Sidebar: The US 10-year yield is at 2.86% as I write. That is up from 2.05% last July, but is still lower than it was little over four years ago, when it hit 3%. Then, 3% 10-year yields didn't stop the bull market.

As you can see, our lender search won't necessarily be quick or easy. There is one sure way to scare up lenders … but it has a few drawbacks.

Coup de Grace

The US financial industry is extremely adept at evaluating credit risk for individual borrowers – or at least it thinks it is. Most folks can get a loan if they want one, but your interest rate will reflect your creditworthiness.

Similarly, Treasury can borrow all it needs by paying higher rates. That's not the preferred outcome, but it is probably what will happen. We are already seeing rates trend upward as the benchmark 10-year climbs toward 3% from near 2% just 8 months ago. This rise also reflects inflation expectations, but the growing supply of Treasury debt is still the key.

Last week may be just a hint of what is coming. Credit markets are nothing more than borrowers competing against each other for lenders. The Treasury competes with investment-grade corporates, who compete with high-yield issuers. Then you have municipal bond issuers and many smaller debtors. They all need cash, but there is only so much to go around.

Rising Treasury issuance will force other borrowers to pay higher rates, which will in turn make Treasuries buyers demand higher rates. The process feeds on itself. Borrowers eventually find debt service taking a bigger bite out of their income. This burden leaves them less to spend on other goods and services.

Meanwhile, as time passes, borrowers who locked in lower rates during the QE years will need to refinance and will find they must pay sharply higher rates. Some won't be able to do so and will go out of business, laying off workers and leaving their own lenders holding losses. This process will be extreme for issuers of high-yield bonds. There is now a drastically increasing amount of high-yield bond debt that has to be rolled over every year.

That process eventually adds up to a recession, which makes government spending rise even more as people lose jobs. How far away are we from that point? I still don't expect a recession this year, but the risks will rise as we get into 2019. From there, the picture worsens quickly.

I don't want to leave you depressed, so I'll stop here. None of this is inevitable, but neither is it unlikely. Now is the time to get ready.

Thoughts from the Frontline

By John Mauldin

On the surface, the film industry and central banking have little in common. Each does its own thing with little regard for the other. But in fact, they're more alike than either cares to acknowledge.

Film executives must analyse the vast, constantly shifting data surrounding public preferences, make long-term financial commitments that aren't easy to reverse, and then live with the consequences. Central bankers must do the same. Hollywood execs dress more fashionably, but otherwise they have a lot in common with Fed governors.

There's one big difference, though: Hollywood's financial mistakes hurt mainly Hollywood, but the Fed's mistakes hurt almost everyone. Hollywood executives have their own skin in the game. They live with the financial consequences of their decisions. The members of the Federal Open Market Committee not only have no skin in the game; if something goes wrong, they will blame capitalism and free markets and thereby relieve themselves of the consequences of their own decisions and manipulations. And then they will go on manipulating the markets to far more applause than they deserve, in the attempt to clean up the consequences of their own mistakes.

Let's be clear. The financial crisis of 2007–08 was the result of Federal Reserve errors and the regulatory failures of government agencies.

When William Goldman wrote, "Not one person in the entire motion picture field knows for a certainty what's going to work," he could just as easily have been talking about monetary policy. Nobody really knows what's going to work. However, if we ask who makes more blockbusters while operating on flawed and limited information, Hollywood wins easily. It has the occasional ***Gigli*** or ***Heaven's Gate***, but the Fed remakes ***Ishtar*** every few years and thinks everything is fine.

Today we'll consider how twisted inflation data leads to less-than-ideal policies.

In the US we have two different inflation measures, produced by agencies of two different cabinet departments. The Federal Reserve prefers to look at the Commerce Department's Personal Consumption Expenditures (PCE) Index, because they believe it is more comprehensive and nuanced than the Labour Department's Consumer Price Index (CPI).

Are they right? In a moment I will talk about the differences, which are important; but I think the Fed is exactly backwards here. Neither measure is particularly foolproof, but the flexibility and adjustments that make the Fed prefer PCE also take the index further from reflecting the average citizen's economic condition. This bias shows up in Fed policy, and not in a good way.

That doesn't mean the CPI is wonderful, though. Unlike some, I don't believe it is intentionally manipulated. I think the wonks (and I say that in a complimentary way, as a fellow wonk) who compile price data do a nearly impossible job as well as anyone can. Browse through the methodological explanations on the CPI home page and you'll quickly see how much effort goes into that work. They have a whole "data available" shopping list:

> • Price indexes are available for the US, the four Census regions, nine Census divisions, two size of city classes, eight cross-classifications of regions and size-classes, and for 23 local areas. Indexes are available for major groups of consumer expenditures (food and beverages, housing, apparel, transportation, medical care, recreation, education and communications, and other goods and services), for items within each group, and for special categories, such as services.
>
> • Monthly indexes are available for the US, the four Census regions, and some local areas. [You can see those indexes here.]
>
> • More detailed item indexes are available for the US than for regions and local areas.
>
> • Indexes are available for two population groups: a CPI for All Urban Consumers (CPI-U) which covers approximately 94 percent of the total population and a CPI for Urban Wage Earners and Clerical Workers (CPI-W) which covers 28 percent of the population.
>
> • Some series, such as the US City Average All items index, begin as early as 1913.

All that data gets worked into "baskets" that try to match the spending habits of typical consumers. That's where the effort starts going wrong. The problem is quite simple and beyond anyone's control: None of us are average.

We all spend our money differently, for an endless variety of reasons that change all the time. When you say inflation is higher than CPI shows while your neighbour says inflation is no big deal, you can both be right. Worse, even someone with spending patterns identical to yours can experience an entirely different inflation rate simply because they live in a different city or state. Or they choose to send their kids to a more expensive school. Or they spend a larger amount on health care and less on goods but more on services. It can get quite nuanced.

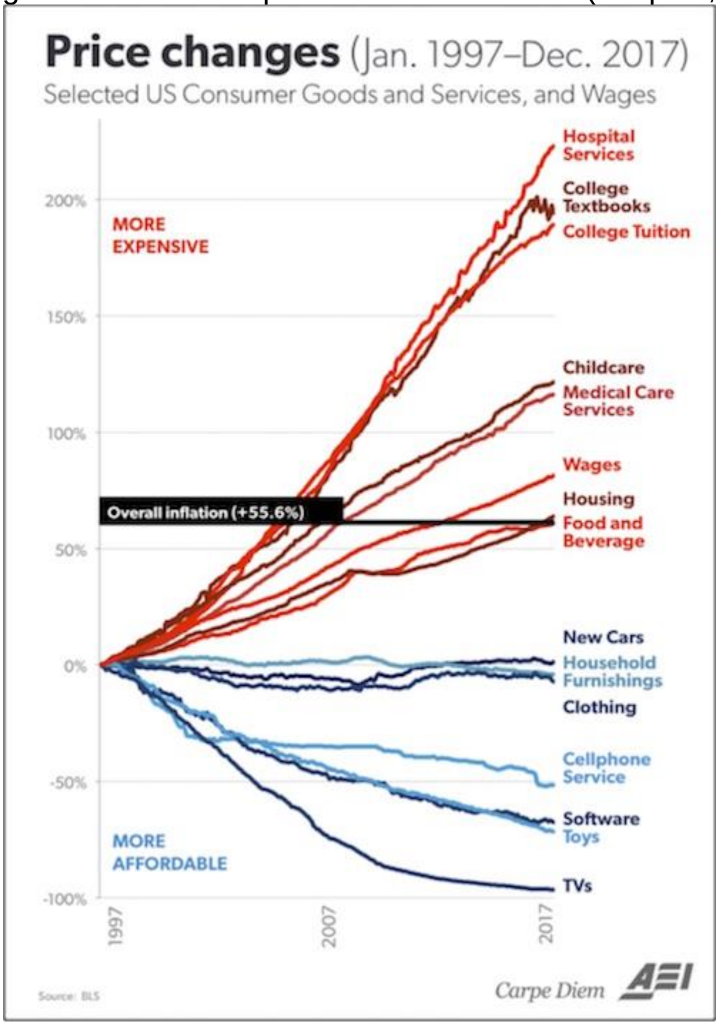
Reducing this complexity to one number and then using that number to guide monetary policy is asking for trouble. And trouble is what we get.

Hedonic Guesswork

CPI isn't entirely useless. It can show us broad price trends over long periods. Those trends can reveal some things, as shown in this 20-year American Enterprise Institute chart that's making the rounds this month.

What jumps out to me is that the highest inflation is in the goods and services over which people have the least discretion. This is particularly burdensome to lower-income Americans. The disinflation that so vexes the Fed impacts more optional purchases. Here's how [my friend Barry Ritholtz] describes the pattern:

> It is notable that the two big outliers to the upside are health care (hospital, medical care, prescription on drugs) and college (tuition, textbooks, etc.).



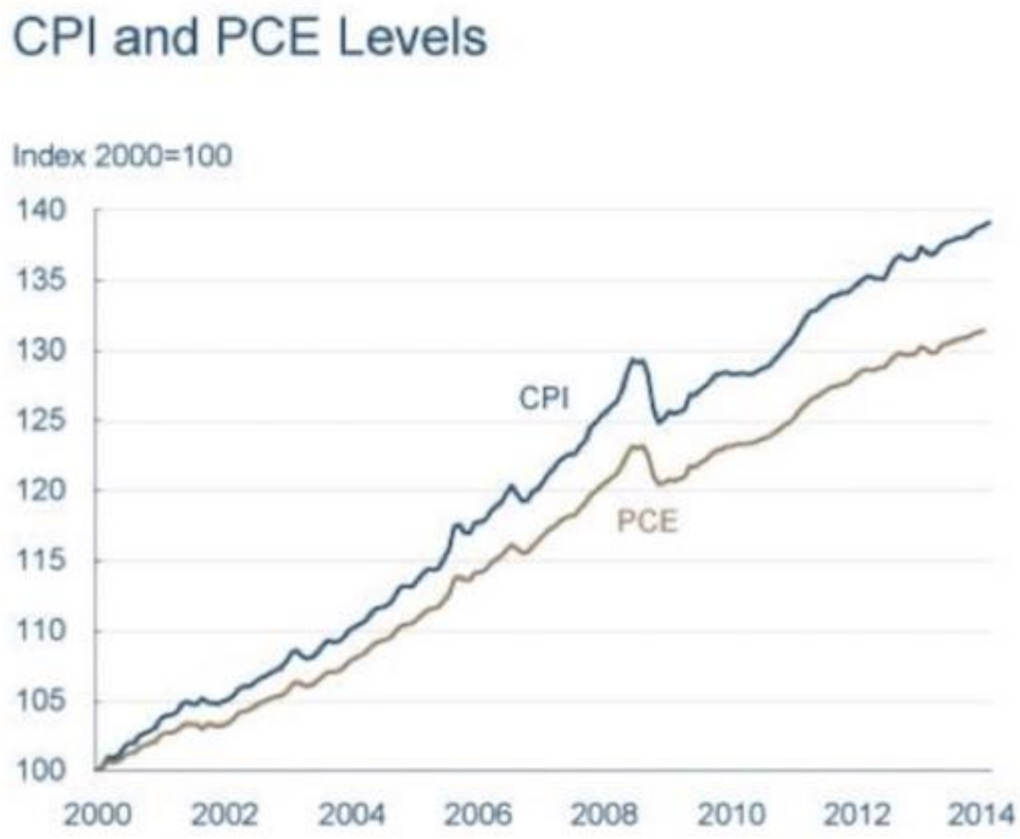
> Clothes, cars, TVs, cell phones, software – technology in general – showed disinflation or outright deflation in prices. (Housing and food & beverage have been right at the middle of inflation levels.)
>
> Wages have barely ticked over the median inflation measure, but that did not stop some people from blaming the correction on rising wages.
>
> Reading the pundits, I cannot tell which fate awaits us: the robot-driven apocalypse where we are all out of work, or the inevitable spike in wages that sends rates much higher and kills the market. Perhaps both – higher wages sends employers into the waiting arms of our automated future.

You can quibble with this data. Have TV prices really fallen 99%? No, unless you hedonically adjust, because today we can buy TVs of a quality that didn't exist in 1997. If you use hedonic prices, adjusting for quality and technological sophistication, then you can argue that the price of TVs is down 99%. But we all know that we are paying less for TVs. Same for other technology goods. But you simply cannot argue that we are paying the same now for new vehicles as we did 20 years ago, even though the cars we buy today are technologically vastly superior to what we could buy back then. These hedonic price adjustments are guesswork.

Still, the broader point seems right. Inflation is a real problem for some people and no big deal for others, yet the Fed uses inflation measures to impose a single monetary policy on everyone. Is it any wonder that policy doesn't work for many of us?

PCE Versus CPI

The Federal Reserve prefers to use core PCE rather than core CPI. The Cleveland Fed has a very good basic explanation of the differences between the two indexes. A glance at their charts, below, will show that core PCE (Personal Consumption Expenditures) is significantly lower than core CPI (Consumer Price Index). After the charts, I will quote a few paragraphs from the Cleveland Fed.



What accounts for the difference between the two measures? Both indexes calculate the price level by pricing a basket of goods. If the price of the basket goes up, the price index goes up. But the baskets aren't the same, and it turns out that the biggest differences between the CPI and PCE arise from the differences in their baskets.

The first difference is sometimes called the weight effect. In calculating an index number, which is a sort of average, some prices get a heavier weight than others. People spend more on some items than others, so they are a larger part of the basket and thus get more weight in the index. For example, spending is affected more if the price of gasoline rises than if the price of limes goes up. The two indexes have different estimates of the appropriate basket. The CPI is based on a survey of what households are buying; the PCE is based on surveys of what businesses are selling.

Another aspect of the baskets that leads to differences is referred to as coverage or scope. The CPI only covers out-of-pocket expenditures on goods and services purchased. It excludes other expenditures that are not paid for directly, for example, medical care paid for by employer-provided insurance, Medicare, and Medicaid. These are, however, included in the PCE.

Finally, the indexes differ in how they account for changes in the basket. This is referred to as the formula effect, because the indexes themselves are calculated using different formulae. The details can get quite complicated, but the gist of the matter is that the PCE tries to account for substitution between goods when one good gets more expensive. Thus, if the price of bread goes up, people buy less bread; and the PCE uses a new basket of goods that accounts for people buying less bread. The CPI uses the same basket as before (again, roughly – the details get complicated).

Now, in conversations with my friend and fellow wonk Peter Boockvar, he has pointed out other, more nuanced differences. The inclusion of government-priced medical care, such as Medicare, where the government manipulates what they will pay, significantly reduces the healthcare inflation of the PCE. And as noted above, the PCE assumes that if the price of something – beef, for instance – goes up, consumers will buy less beef and more chicken, which is cheaper.

You can make the argument that the PCE is biased toward returning lower inflation numbers, but that tendency is almost beside the point. The technical differences between the two indexes make for extraordinarily economically dense discussions, and I'm sure the issues are debated heatedly at certain conferences that focus on such things, but both measures are honest attempts to understand what inflation is and how it affects us. Neither index necessarily reflects the inflation that you are personally experiencing, or the inflation of your particular area or region. And similar differences pertain in every country of the world.

But in most countries, inflation affects the bottom 50% more than it does the top 50% by income. Because there are certain necessities of life that must be purchased, and because many of those goods and services (such as housing, and health care) have higher than average inflation, the bottom half suffers a much higher inflation rate than the overall national average.

And yet, a national inflation policy geared to the lower 50% would aggressively skew monetary policy in a negative fashion.

Sidebar: PCE and CPI use different measures and percentages for housing costs. CPI uses something called Owner's Equivalent Rent, which is a hypothetical number based on certain assumptions. Here's a thought project. At one time the US used actual house prices to measure inflation, as Europe does today. If we had been using actual house prices during the period 2000 to 2008, the Fed would have been raising rates aggressively, trying to lean into the inflation caused by the increase in house prices, thereby likely avoiding the housing bubble but creating a recession earlier than 2008, for entirely different reasons.

Tell me again why 12 people sitting around a table should set interest rates based on data they don't understand, in a market that is way too complex? More loans are based on LIBOR than anything else. And we trust a rather complicated market process, which can somewhat be manipulated, to set the price of LIBOR. Manipulating interest rates in the broader market would be far more difficult and would lead to interest rates that are more reflective of what is going on in the marketplace. Just saying…

Disinflation Fixation

In theory, we want "price stability," which would mean the absence of either inflation or deflation. When Greenspan was asked, when he was chairman of the Fed, what is meant by price stability, he answered "Zero." None of this 2% inflation target. "Price stability" is the obsession of central bankers everywhere, and in some places is their legal mandate. They currently like having just a little inflation but not too much. The Fed wants 2% and can't even deliver that, if you define inflation by CPI or PCE. People think that 2% coming. Maybe so.

However, maybe we should all think about this issue differently. Last week I ran across a December 2017 Project Syndicate article by good friend William White, formerly Bank of International Settlements chief economist and now with the OECD. Bill is my favourite central banker in the world. (The full article is well worth reading.)

White says central banks rightly responded to 1970s inflation by clamping down hard, but then failed to adjust when conditions changed. That oversight led directly to some of today's problems.

From the late 1980s onward, low inflation was largely due to positive supply-side shocks – such as the Baby Boomer-fuelled expansion of the labour force and the integration of many emerging countries into the global trading system. These forces boosted growth while lowering inflation. And monetary policy, far from restricting demand, was generally focused on preventing below-target inflation.

As we now know, that led to a period of easy monetary conditions, which, together with financial deregulation and technological developments, sowed the seeds of the 2007 financial crisis and the ensuing recession. The fundamental analytical error then – as it still is today – was a failure to distinguish between alternative sources of disinflation.

The end of the Great Moderation should have disabused policymakers of their belief that low inflation guarantees future economic stability. If anything, the opposite has been true. Having doubled down on their inflation targets, central banks have had to rely on an unprecedented array of untested policy instruments to achieve their goals.

The fixation on keeping inflation low, according to White, has driven up global debt ratios, squeezed lender margins, and forced lending activity into an opaque shadow banking sector. All these effects raise systemic risks that will probably bite us eventually.

Here's Bill again, with a thought-provoking point I've formatted in bold.

These developments constitute a threat not just to financial stability, but also to the workings of the real economy. Moreover, **one could argue that easy money itself has contributed to the unexpectedly strong disinflationary forces seen in recent years.** Owing to easy financing and regulatory forbearance, **aggregate supply has risen as "zombie" companies have proliferated. Meanwhile, aggregate demand has been restrained by the debt headwinds** – yet another result of easy monetary conditions.

This insight isn't intuitive to many economists. Easy credit – as the Fed gave us for the last decade – should ***raise*** inflation, not reduce it. Bill says no; it allows zombie companies to survive and overproduce, while putting consumers in so much debt that their spending gets constrained. So it pushes inflation down instead of up.

Wrap your head around that thought. It answers some riddles that otherwise make little sense. But it also highlights the difficulty of formulating sane policy. Yes, it's important to let zombie companies die. Creative destruction and all that. But real people work for the zombies, earning real money that lets them buy goods and services and keep the economy moving. So what do you do? None of the choices are painless.

Too often, we simply redistribute the pain to those least able to bear it, who are understandably unhappy – hence the present social and political tensions. They all trace back to economics.

Is data boring? Yes. It's often wrong and misleading, too. But ignoring it to fly by the seat of our pants isn't the right response, either. We need much better understanding and application of all these numbers, and I see very few economists trying to deliver either. That’s the core problem.

I am getting close to going on too long here, so the prescription for what we should be doing will come in future letters. Suffice it to say that using data that is fundamentally flawed as a “guide” to monetary policy creates the rather strange outcomes that we see. I get extraordinarily angry when central banks and big government proponents argue that it is capitalism and free markets, rather than manipulation and inappropriate regulation, that are the problem. The monetary policymakers never see themselves as the problem. This blind spot is just a corollary to one of my favourite Paul Simon quotes: “A man hears what he wants to hear and disregards the rest.”