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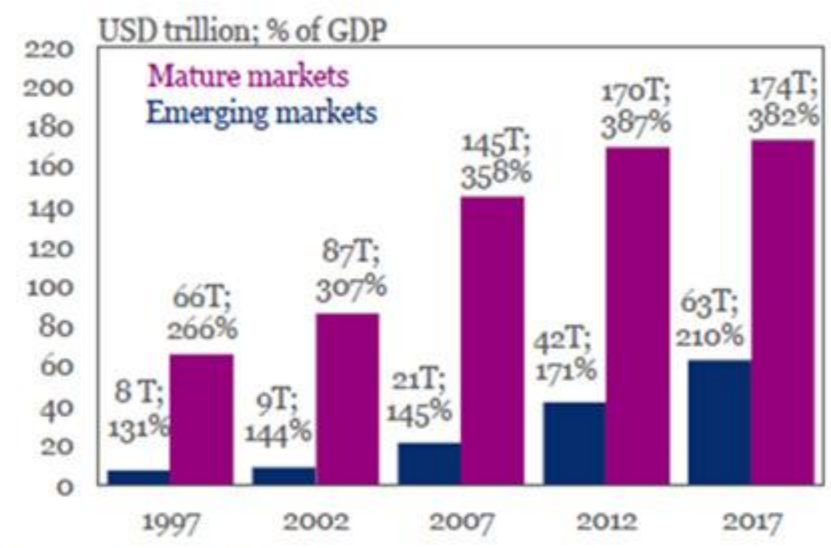
A Crisis ahead of us

By Richard Cluver

I sometimes wonder whether our readers read all the way to the end of this publication which regularly exceeds 20 pages in length and, if you were one who did not you might well have missed a graph which has haunted me for the past four weeks?

Dealing with an issue that has been a central theme of many of his writings – and mine for that matter – for the past many years, he raised the now certainty of a global economic melt-down which has been building up for at least two decades. He cited as proof a calculation by the International Monetary Fund which claims that the sum of all global indebtedness has now passed $174-trillion or 382 percent of global Gross National Product. I reproduce the IMF graph on the right for you to ponder.

Chart 1: Total Global Debt Stock Continues to Rise



Source: IIF, BIS, IMF

To understand what it means, Gross Domestic Product is the sum of all income earned by the endeavors of men, women, businesses and corporates. So to put that figure simply, it implies that if all the earnings of humankind and all the corporates that employ them were to be combined and used to repay the accumulated debt, it would take 47 months of their combined efforts.

Were all of that debt to be denominated in South African sovereign bonds at a current yield of 8.73 percent, then the implication is that a third of global incomes are pouring into meeting the interest costs of the debt.

Furthermore, the sum of that debt rose at an 8.5% compound rate from 1997 to 2007. Then it slowed to 3.6% from 2007 through 2017. But last year, we appear to have binged because debt grew 10.2% from 2016 to 2017. Breaking it down by sector, non-financial corporate debt grew 11.1%, government debt grew 6.7%, household debt grew 12.5%, and financial sector debt grew 11.3%, all in calendar 2017.

If the latter rate were to continue, two thirds of all earnings would be required within seven years to simply meet the interest costs and everything we earn would be needed within 14 years.

So we have a finite absolute end date which implies that sometime within the next 14 years the global economic system will inevitably collapse. Furthermore, as risk rises the price of the risk increases and so every year the cost of that debt expressed in the interest it will attract is likely to increase exponentially which leads me to the inevitable conclusion that the point of collapse is likely to be closer to seven rather than 14 years.

Previously, when nations got themselves severely indebted they went to war against those whom they had borrowed from. But now the lenders are somewhat opaque. Broadly speaking, however, the world's principal lenders are its pension funds which in most countries are required by law to hold at least a third of their capital reserves in sovereign bonds.

So, if nations were to renege of their debts, as they inevitably must, then the people who will pay the price are the pensioners of this world. To put that bluntly, if nations find themselves no longer able to meet their debts, it will be the pensioners who will pay the price.

All of which leads me to the point that if you are hoping to rely upon a pension when you retire or, if you are already retired and reliant upon a pension, then you have very little time to make alternative plans!

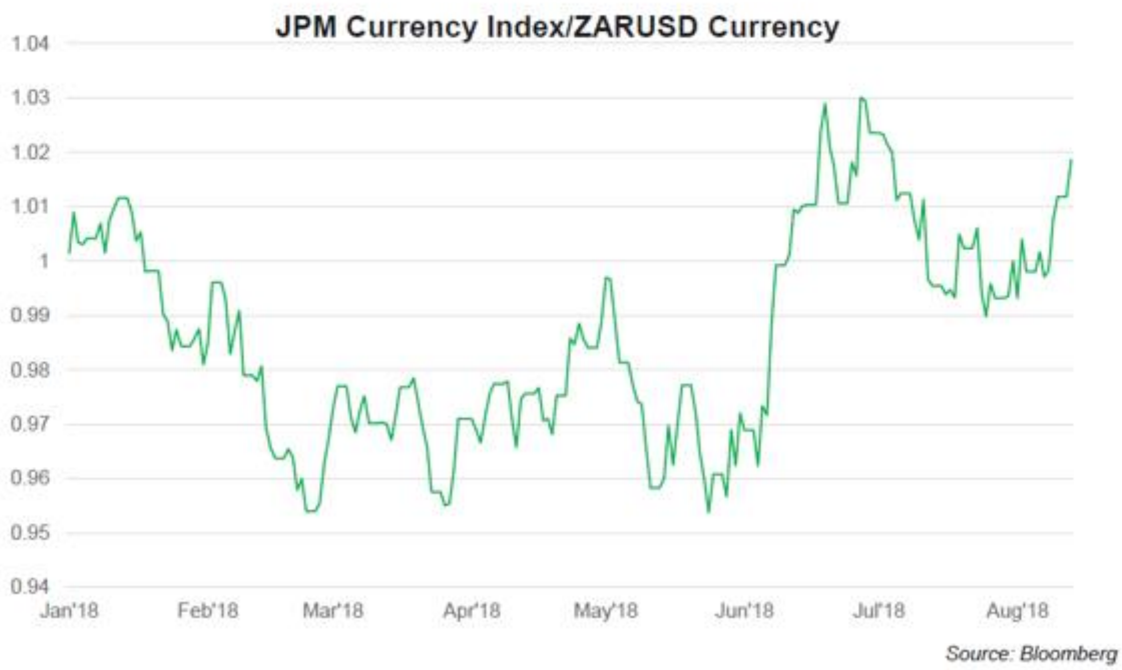
Talking Turkey about the rand

by Brian Kantor

How best to respond to rand weakness that has nothing much to do with SA

The SA economy has been subject to a new sharp burst of unwelcome rand weakness. Weakness that would appear to have little to do with events political or economic in SA itself. It has been a reaction to the shocks that have overwhelmed the Turkish lira. Weakness in other emerging market exchange rates has been part of the collateral damage.

The Turkish lira has lost 34.79% of its US dollar value since the July month end – from USD/TRY4.91 to USD/TRY6.96 by 14h00 on 13 August. The USD/ZAR was 13.27 on the morning of 1 August and was at 14.38 yesterday afternoon, a decline of 7.97%. But it should be recognised that the rand has been a marginal underperformer within the emerging market (EM) peer group. The JPMorgan EM currency benchmark, which includes the Chinese Yuan with a 11% weight, has lost 6.1 per cent of its USD value over the same period (see figures below where in the second, the relative to other EM currencies underperformance by the rand, shows up as a higher ratio).



A weaker rand leads to more inflation that depresses the spending power of households. It may also lead to higher interest rates, given the reaction function of the Reserve Bank. The Reserve Bank believes that higher inflation will lead to still more inflation expected and hence still more inflation as a self-fulfilling process. That is unless demand is suppressed even further with higher interest rates. This is described as the danger of so-called second round effects of inflation itself (for which incidentally there is little evidence, when demand is already so depressed). The typical SA business now has very limited power to raise prices, as has been revealed by little inflation at retail level. A still weaker rand is likely to further restrain operating margins and the willingness of SA business to invest in plant or people.

We have long argued that this represents a particularly baleful approach by the Reserve Bank to its responsibilities. We have recommended that the Reserve Bank not react to exchange rate shocks, over which they have little influence. Moreover, that raising interest rates can further depress demand without having any predictable influence on the exchange rate itself.

Indeed we have argued that slow growth itself weakens the case for investing in South Africa. Slow growth to which monetary policy can contribute adds investment risk without any predictable influence on inflation because the value of the rand is itself so unpredictable.

The best the Reserve Bank can do for the economy at times like this, when the rand is shocked weaker, is to say very little and do even less and wait for the shock to pass through – as it will in a year or so. The statement of the Deputy Governor, Daniel Mminele, made yesterday that “The South African Reserve Bank won’t intervene to prop up the rand unless the orderly functioning of markets is threatened” is to be welcomed.

The weaker rand, for whatever reason, discourages spending and weakens the case for investing in any company that derives much of its revenue from South African sources. Companies listed on the JSE that derive much of their sales offshore stand to benefit from higher revenues recorded in the weaker rand. These include the large global industrial plays that dominate the Industrial Index of the JSE by market value. Included in their ranks are Richemont, British American Tobacco and AB Inbev.

Even better placed to benefit from a weaker rand will be companies with revenues offshore but with costs incurred in rands. The increase in these rand costs of production may well lag behind the higher revenues being earned in rands, so adding to the operating margins enjoyed. Resource companies quoted on the JSE with SA operations fall into this category. Kumba and the platinum companies, as well as Sasol, are examples of businesses of this kind.

But the appeal of global and resource plays for investors will also depend on the prevailing state of global markets. Global strength will add to their value measured in USD and even more so when these stable or higher dollar values are translated into rands at a weaker rate of exchange. In such circumstances, when the rand weakens for SA specific reasons, rather than for adverse circumstances associated with a weaker global economy, the global and resource plays on the JSE have additional appeal.

The additional weakness of the rand, when compared to other EM currencies, may well have added to the appeal of JSE global and resource companies. The movements on the JSE on 13 August – at least up until mid-afternoon – do suggest that a degree of rand weakness for partly SA specific reasons- has been helpful for the rand values of the JSE global and resource plays. This is shown below. The global industrial plays and Naspers, another very important global play, have moved higher with JSE Resources. The SA plays have weakened as may also be seen and would have been predicted.

The four forces of the JSE (2018=100)

Source: Bloomberg and Investec Wealth & Investment

The news about the global economy may not have improved with the Turkish crisis. Nor however is the global economy greatly threatened by the state of the Turkish economy. The weakness of the Turkish Lira would appear to have much to do with the unsatisfactory state of Turkish politics. The risk is that Turkey is less willing to play by the rules of international diplomacy and business and may be isolated accordingly. A serious spat with the USA has led to economic sanctions being placed on leading Turkish politicians to which Turkey has responded with outrage rather than negotiations with the US.

The lesson for South Africa is to remain fully committed to global trading and financial conventions. To reinforce its attractions as an investment destination at times like this when the rand comes under pressure. This will help support the rand and the prospects for the SA economy.

The Distribution of Pain

By John Mauldin

When you write about economics, you quickly learn the economy doesn't care what you say. The forces that drive it are beyond any one person's comprehension, much less control.

But at the same time, the economy doesn't work like a law of nature. Unlike gravity, for instance, the economy responds to human choices and preferences. We influence it, even if we don't understand exactly how.

In my 2017 "Fragmentation of Society" letter, I wrote about the coming technological changes that will replace many human jobs and disrupt society. Some of the disruption will be good and necessary. Much of it will be painful, too, and the pain won't be evenly distributed.

That is a problem whether you personally feel it or not. People don't like pain. They change their behaviour to avoid or relieve it. People in pain will vote for politicians who say they can help, regardless of whether they actually can. And if those who suffer see you don't share their pain, they will wonder why not and want whatever advantage you possess. Then it gets ugly. That's not a moral statement but simply a fact-based observation of human nature.

The natural stratification of society, which is something I really deplore (but it is also reality), means we at the upper end of the financial spectrum have little interaction with or knowledge of the people who feel the most pain. I wrote about this chasm between classes in 2016 (see "Life on the Edge") as the US election made the split in our nation harder to ignore.

It doesn't matter that I began life on the wrong side of the tracks in West Texas. Dad was an alcoholic, and we were poor. But a few lucky breaks and a lot of hard work (the harder I worked, the luckier I got) got me to the upper end. And without knowing the story, most people assume that is how my life began. But I remember. I have more sympathy than you might imagine for those who are struggling.

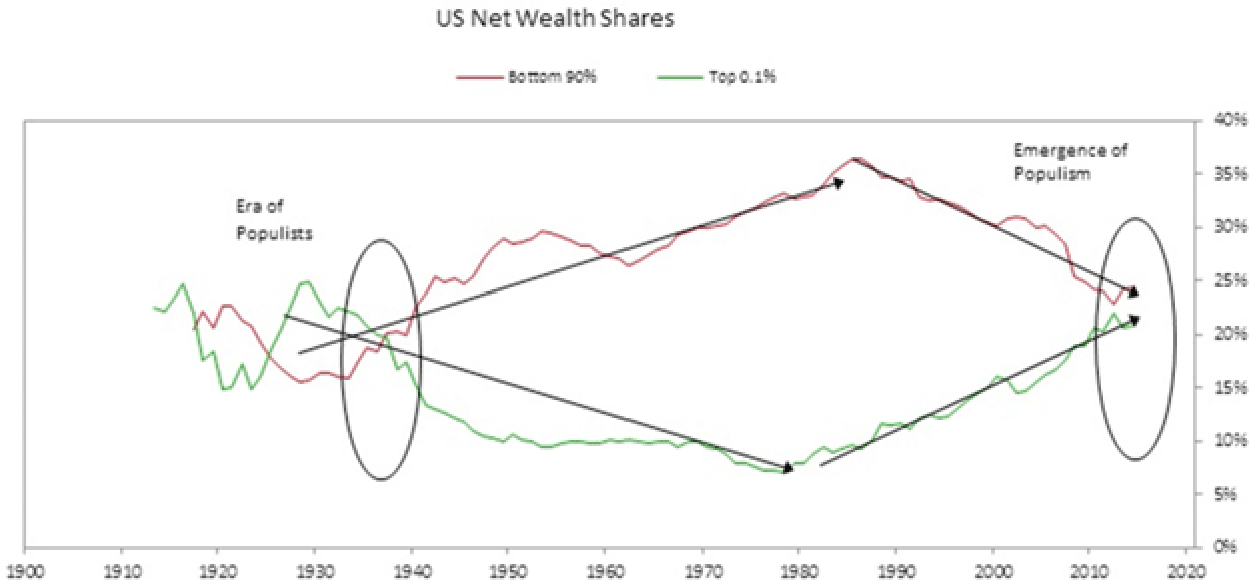
Peggy Noonan talks about the "Protected" class that makes public policy and the "Unprotected" who must live with those policies. Today, I want to delve a little deeper into this widening split and consider where it may take us. As you'll see, the possibilities range from "not so bad" to "very, very bad."

The Two Economies

Ray Dalio is no stranger to my readers. The billionaire founder of top hedge fund Bridgewater Associates got where he is by having keen insight into both human nature and economic trends. Occasionally he shares some of his wisdom publicly. I featured his reflections on the then-forthcoming Trump presidency in ***Outside the Box*** after the 2016 election.

In October 2017, Dalio posted a new article, "The Two Economies: The Top 40% and the Bottom 60%." He wrote that it is a serious mistake to think you can analyze or understand "the" economy because we now have ***two*** economies. Wealth and income are so skewed between top and bottom that "average" indicators no longer reflect the typical person's experience or living conditions.

Dalio launches with this chart:



Source: Ray Dalio

The red line is the share of US wealth owned by the bottom 90% of the population, and the green line is the share held by the top 0.1%. Right now, they are about the same, but notice the trend. The wealthiest 0.1% has been increasing its share of wealth since the 1980s, while the bottom 90% has been losing ground.

Looking back, we see a similar pattern in the 1920s—which dramatically reversed in the following decade. Then there was an almost 50-year period during which the masses gained wealth and the wealthy lost ground.

(Important note: This doesn't mean the 0.1% ceased being wealthy. It just means they owned a smaller portion of the total wealth. An economy in which 0.1% of the people own 10% of the wealth is still skewed, just less so. But more on that later.)

In the big picture, we see about a half-century when the net wealth gap widened in favor of the bottom 90%, followed by another 30 or so years in which the wealthiest gained ground while most of the population lost it… at least in terms of total national aggregate wealth.

I have written elsewhere that wealth is relative. Most of the bottom 90% have better lives today than 38 years ago. But they don't compare life to where they were in 1980, but to today. They see income and wealth relative to the current economic "totem pole," not the one from 30 years ago. Now, maybe you don't have those feelings, but unfortunately many of our neighbours do. Thus, the political split.

It's no coincidence that populism emerged as a political force in both the 1920s–1930s and the 2010s. In each case, people at the bottom could tell that the economy wasn't working in their favour. Their best tool to do something about it was the vote, so they elected FDR then and Trump now—two very different presidents but both responsive to their era's intensely angered voters.

And I would note that Bernie Sanders reflected that same angst on the left. I fully expect that a younger, more rational, and appealing "Bernie Sanders" (even, and maybe especially, if it is a woman) will be the Democratic flag bearer in 2020.

Looking back further in Dalio's chart, that previous roughly 10-year period, in which the green line was above the red line, included the Roaring 20s, the 1929 market crash, and the first part of the Great Depression. For the 0.1%'s share of the wealth, 1929 was roughly the high point. Wealth lost in the crash sent their share plummeting. It has not fully recovered to this day, but it's getting close.

Thinking about this situation, I can't help but connect it to my friend Neil Howe's idea of a "Fourth Turning" every 80 years or so. It fits well with Dalio's data. Neil argues we are in the last half of that Fourth Turning, and he expects conditions to worsen from here. As he points out, for almost 500 years, the last half of Fourth Turning has always encompassed the most tumultuous times in Anglo-Saxon history.

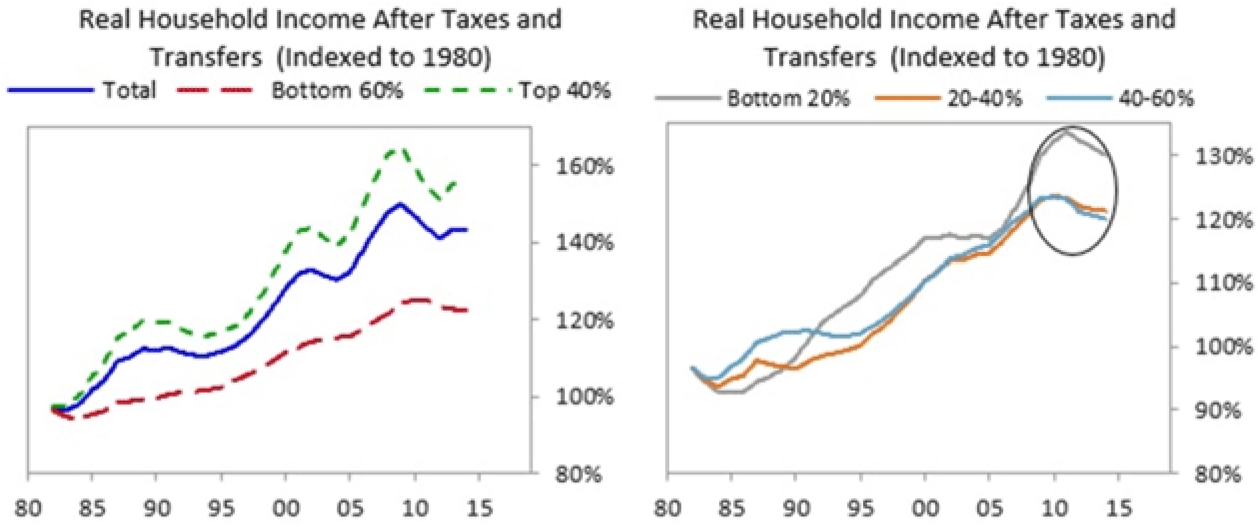
(A Fourth Turning is a time when society's foundational institutions are challenged. The generation who are young adults at that time must face the challenge, and hopefully overcome it. The so-called Greatest Generation did so by persevering through the Great Depression and fighting World War II. It may not be a war, but Neil says the Millennial Generation will face a similarly consequential test.)

Back to Dalio's article, he quantifies the 60/40 split with some startling numbers. Just a sampling:

- The average household in the top 40% earns four times more than the average household in the bottom 60%.
- Real incomes for the bottom 60% have been either flat or down slightly since 1980.
- In 1980, the average household in the top 40% had six times more wealth than the average household in the bottom 60%. Now, it is 10 times as much.
- Only about a third of the bottom 60% saves any of their income.

Dalio also found some very useful data: household income adjusted to show the impact of taxes, tax credits, and government benefits. This adjustment gets closer to the resources people actually have available for living expenses, savings, and investment. The Heritage Foundation has similar studies from a different perspective, but they generally agree.

Splitting that data by the top 40% and bottom 60%, we see a sharply growing difference in the percentage changes since 1980. The top saw its ***after-tax*** net household income grow almost ***three times faster*** than household income for the bottom 60%, even including government transfer payments.



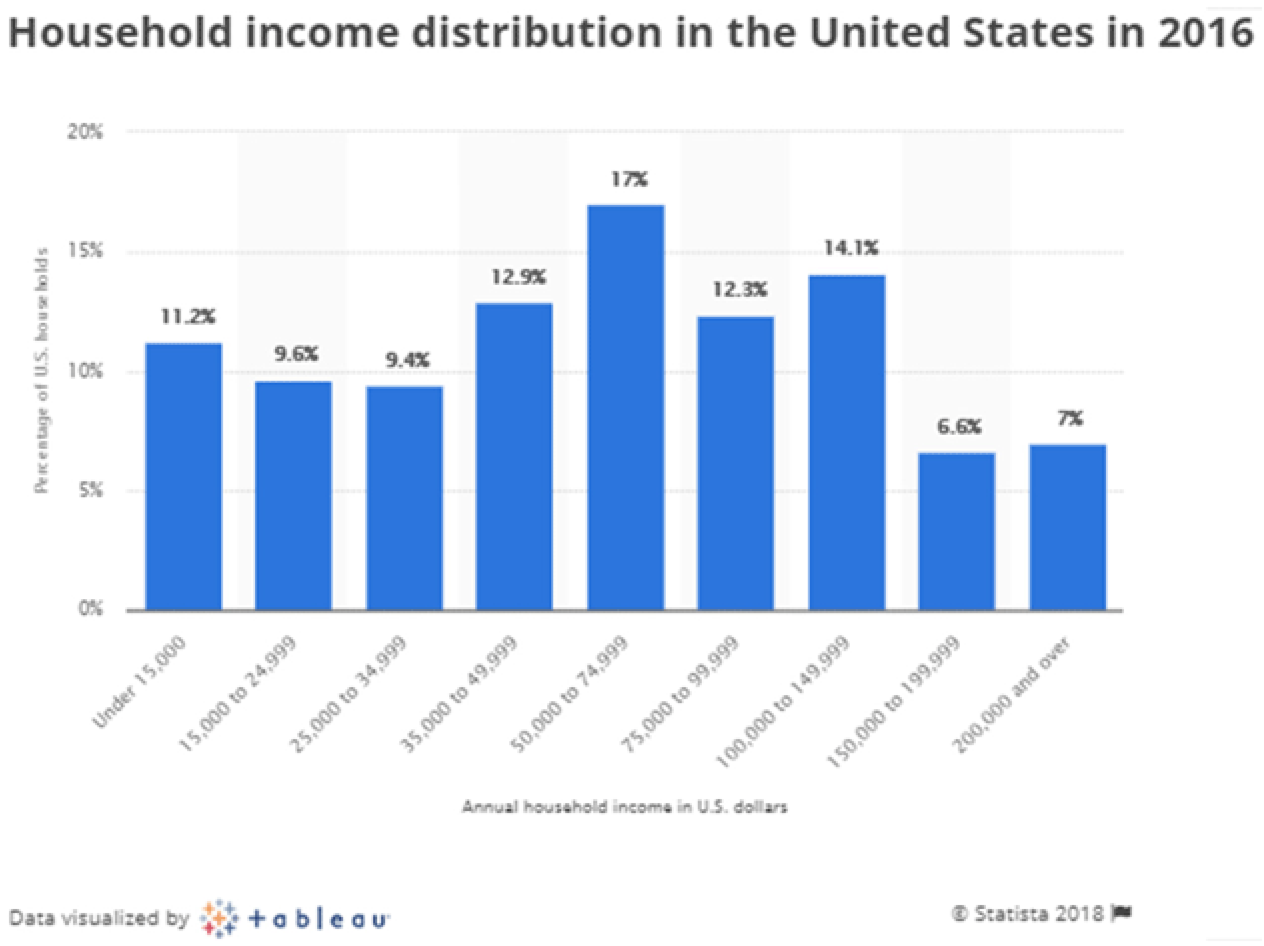
Source: Ray Dalio

And note something in the right-hand side of the chart, which depicts income changes for the bottom 60% only, divided into three segments. There is a significant difference in the income growth of the middle 40–60% segment and the bottom 20%, and that difference accelerated during and after the Great Recession. Think about that in the context of recent political trends.

You see the problem here? The bottom 60% know their own experience. Thanks to the internet and social media, they are particularly aware of the gap and increasingly resentful.

Note also that the lower ranks of the top 40% are not "wealthy" by any stretch. Anyone below the 80th percentile is probably struggling to some degree. This Statista chart shows you need to make at least $75,000 a year to get into the top 40%. Maybe I'm jaded, but I don't think $75,000 a year is wealthy. I can guarantee you that my friends in the $150,000 to $200,000 range may feel comfortable, but they certainly don't think of themselves as wealthy.

Dalio is right to compare the top 0.1% to the bottom 90%. That skew at the very top creates the illusion that there are a large number of extraordinarily wealthy people when in fact there are just a few. But if you throw Bill Gates or Warren Buffett into the demographic, you raise the average net worth significantly. Which is why "average" is so misleading.



Source: *Statista*

Since the 1980s, most of us at the top have believed that a rising tide would lift all boats. We were half-right: It has lifted all the boats but not at the same rate, and many boats have sprung holes and are taking on water. Our differences in income and wealth are getting too great to ignore.

Think back 30 years. None of us would want to go back and live with the same technological base we had back then. All of our lives have dramatically improved. From health care to communications to entertainment to transportation and a host of other things, we are ***all*** better off in many ways

Nevertheless, and repeating myself, those in the bottom 20 or 40 or 60 or 80% notice the ***relative*** differences between where they are and where the top 10% or 1% reside, and they can see those differences growing.

While many in Africa, in some parts of Asia, and in the slums in Latin America would see the lives we call "poor" in the US as vastly superior to their own, that is not who the bottom 20–40–60% of the US income strata are comparing their lives to. It is simply human nature that we compare ourselves to those who have more, and to want more for ourselves.

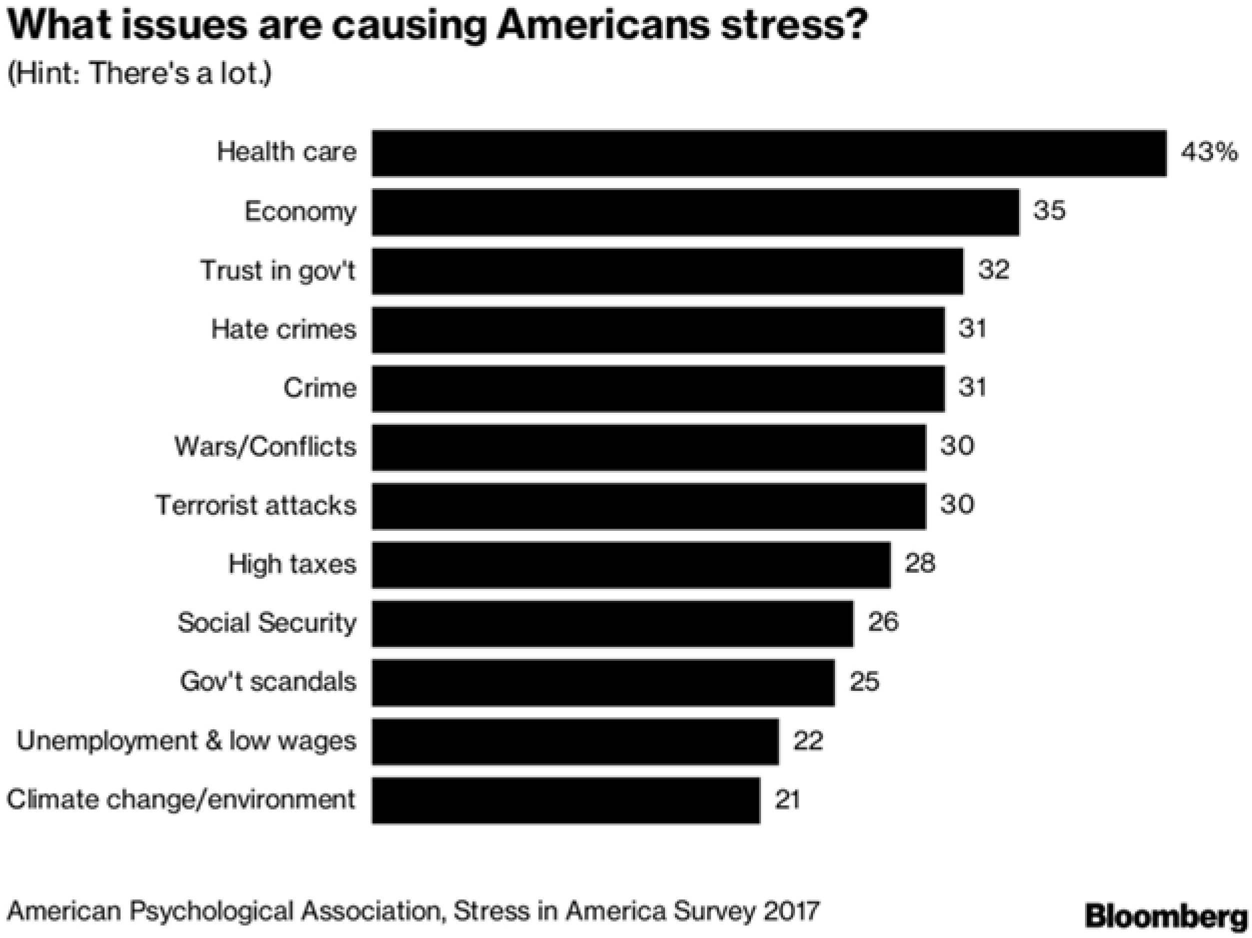
Leveraged Stress

The American Psychological Association does an annual survey on "Stress in America." Not surprisingly, the most recent one shows we are not happy campers.

A big majority (59%) think we are now at “the lowest point in our nation’s history.” To me, that seems a stretch, given that we killed each other in staggering numbers in the Civil War. And the crash of 1873 and its aftermath wasn’t pretty. Neither was the Great Depression. But then, people didn’t watch the fighting on their phones. Now we do, and it fills us with anxiety.

I look back on my youth and realize that the late ’60s was the first time when the reality of war confronted my generation in our homes, on our TVs and in our newspapers, every day. Media coverage of social turmoil in that era was a harbinger of what the internet and social media have created today: instantaneous analysis of almost everything, much of it by people with no real understanding of the situation. Now, social media have become a monstrous breeding ground for conspiracy theories of all kinds. It is most disheartening.

The specific issues that worry people are interesting.



Source: American Psychological Association

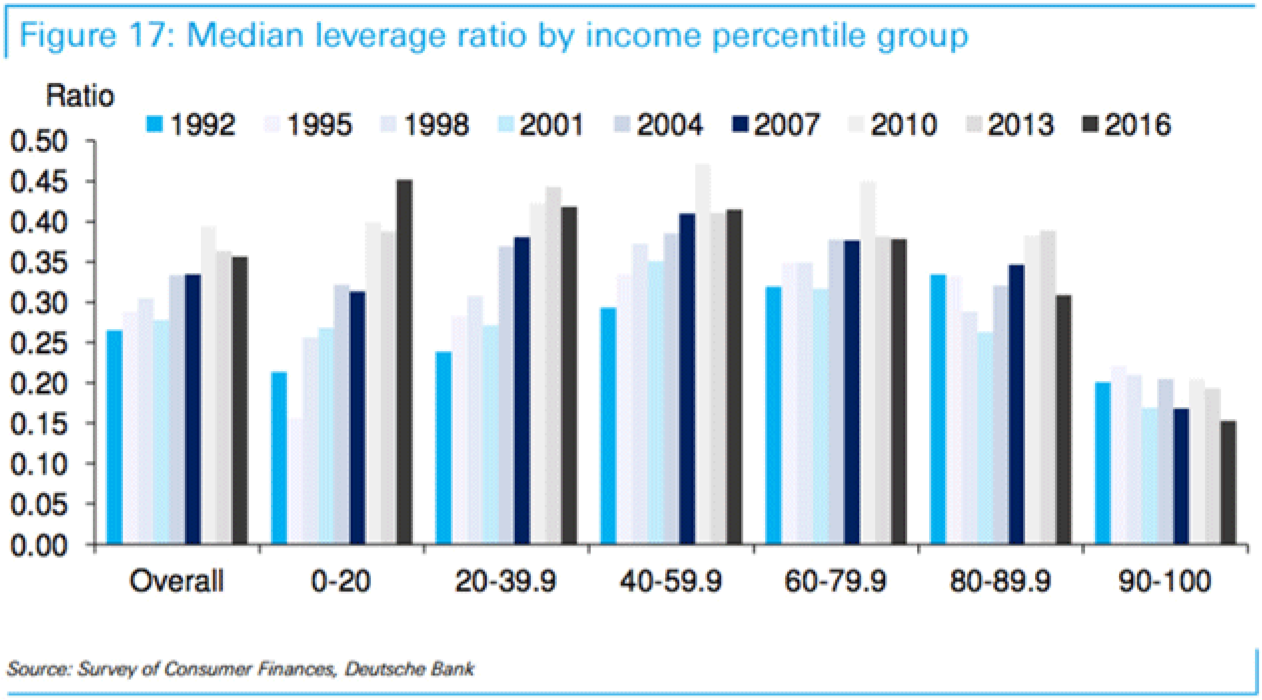
First on the list is health care, by a pretty wide margin. That concern can cover a lot of territory. Maybe you or a family member are seriously ill, or maybe your health is fine but buying insurance causes financial stress.

Just over a third of respondents reported that the economy causes them stress. That seems a little low, but I remind myself that most people don’t observe the economy the way I do. “High taxes” are well down the list, at 28%. That’s surprising but probably reflects the fact that a small number of people pay most of the income taxes.

“Unemployment and low wages” is also near the bottom with 22% of respondents stressed about it. Maybe that figure reflects today’s low unemployment level, or maybe people are just glad to have any sort of job.

One source of considerable stress that isn’t on the list but probably should be is household debt. I talk a lot about government debt and pension debt, but for most people, the more immediate concern is probably their mortgage, auto, credit-card, and student loan debt. There is a mountain of it.

Here’s an interesting Deutsche Bank chart on that point.



Source: Deutsche Bank

Here we see household leverage ratios spanning 1992–2016, broken down by income quintiles. Focus your attention on the 1992 (darker blue) and 2016 (rightmost black) bars. In that 24-year interval, leverage more than doubled for the lowest-income 20% and rose significantly for the lower-income 80% of the population. It ***dropped*** slightly for the 80–89.9th percentiles and even dropped even more for the top 10% income group.

Now recall Dalio’s data on household income, adjusted for taxes and benefits. The top 20%, whose incomes grew the fastest, managed to ***reduce*** their leverage. The lower groups, whose income was up slightly or flat, added large amounts of debt, with the poorest adding the most, percentage-wise.

This data doesn’t tell us what specific kinds of debt create these leverage ratios. Maybe some of the debt is productive, like mortgages on reasonably valued homes or student debt that helps borrowers eventually raise their incomes. But I’d bet much of this borrowed money is simply gone, having bought little or nothing of lasting value.

This likely unrecoverable debt also appears as an asset on some lender’s balance sheet. It ends up being sold as asset-backed securities, possibly to a mutual fund or pension fund near you. And it’s generally in the high-yield category, with leverage on it.

At the risk of repeating the obvious, debt that can't be repaid won't be. Somebody will eat the loss; the only question is who. Banks managed to socialize much of their losses in the last recession. I'm not sure that plan will work a second time.

I started off talking about pain and how we distribute it. It may not be physical pain. Financial and employment-related pain are very real. Boredom, too, can be painful, as can loneliness or the feeling that no one needs you. We're on the verge of many medical breakthroughs, but we won't cure every disease or heal every kind of wound. People will still suffer, and it's clear we need a lot of societal as well as personal healing.

Working Class Versus Service Class

We have long had this notion of the "working class." These are the people who don't own businesses and are not "professionals" like doctors, lawyers, or accountants.

I have spent a great deal of time thinking about the future of work. It is the single most difficult chapter to write in my upcoming book, partly because I don't like the conclusions I'm coming to. One thing I am realizing is there is a distinction between what we have seen as the "working" class and what I am coming to see as the "service" class.

A working-class person is somebody who has a trade, and because of that skill, can generally command a decent income.

The service class—bar and restaurant workers, retail salespeople, general manual laborers, and so on—is almost plug-and-play. It is not that the greedy restaurant owner doesn't want to pay his staff more; it's that competition generally won't let him do so and still make a profit. So, he holds his labour costs down—and he can do so because in today's market, there are typically more people available for these jobs than there are jobs. And because of the Obamacare mandate, if you are a business with more than 50 employees, you simply cannot afford to have full-time employees, so you resort more and more to part-time positions, which don't let workers earn adequate wages.

We are increasingly a nation under stress. Dalio talks about it in terms of the bottom 60% versus the top 40%, but he could have made the same case using an 80–20 model or even a 90–10 model. I am reminded of Pareto's 80/20 principle, which states that roughly 80% of effects come from 20% of causes.

Our socioeconomic situation is not going to improve for a long time. Let's assume, wildly optimistically, that the US economy and the rest of the developed world grow at a 5% nominal rate for the next 15 years, so that our economies roughly double. Will the gap between the lower 60% and the upper 40% grow even wider? We will have more than a few people worth more than $100 billion, that's for sure.

Will the lives of the lower 60% be significantly better than they are today? Absolutely. They'll have improved health care and health spans (***if*** they have access to health care), lower food costs, far more access to services, etc., but the ***relative*** differences will be even greater between the top and the bottom.

Unless we somehow figure out how to help people deal with their stress and better manage the yawning differences in incomes and outcomes, we’re going to see increasing tension and fragmentation in our society.