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How safe is your pension?

By Richard Cluver

Predicting that the International Monetary Fund would be obliged to move its headquarters from Washington to Beijing within the next decade, Investec strategist Dr Michael Power argued at a client presentation this month that the move would be occasioned by China overtaking the USA as the world's economic super power.

Such a move would, of course have profound implications for the world's monetary system, not the least would be whether the US Dollar will remain the global reserve currency. Being the world's banker is what has allowed the US to run up a national debt to GDP ratio currently calculated to exceed 320 percent while South Africa faces economic melt-down because our own ratio might soon exceed 60 percent.

Since the issue of global debt is increasingly preoccupying the world's leading economists, I asked Dr Power whether he did not think that the fast-approaching "Day Zero" when the world's governments run out of the ability service their debts, would lead to a monetary crisis of epic proportions which would, in consequence, arguably cause dramatic social change such that by comparison the Great Depression would be looked back upon as a minor event in history.

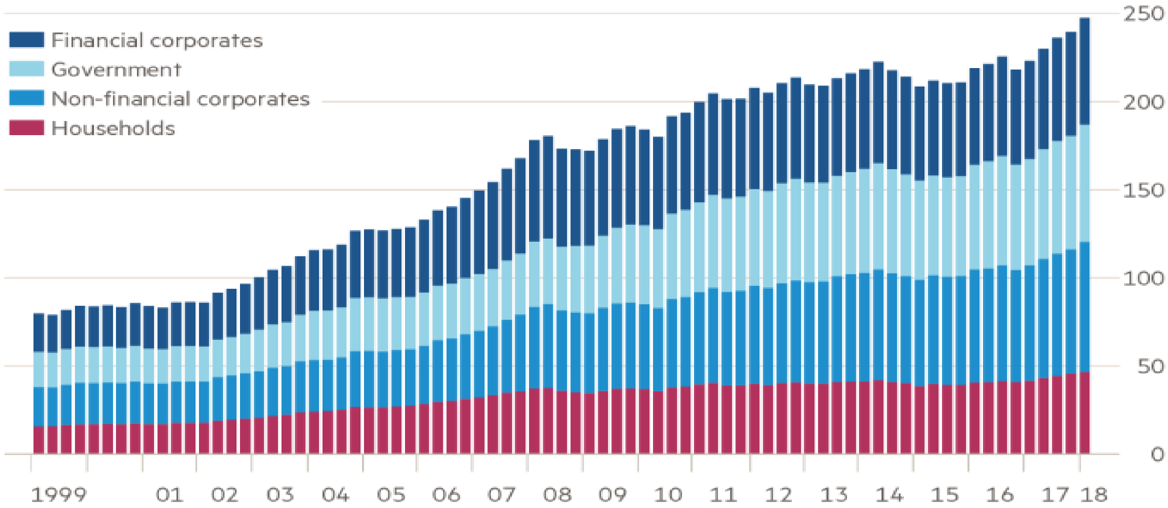
Power's response was that he did not think it would happen because "…it is unthinkable." He added that were the US to renege upon its debt responsibilities it would be "… the end of the monetary system as we know it".

I accordingly refer readers to arguably the most important issue this publication has addressed this past year: the looming question of global debt and the probability of the massive economic dislocation it will inevitably cause.

The problem is already so severe that it cannot be unwound without the world taking considerable pain. But like Global Warming, the consequences of not tackling the debt mountain now is the certainty of an even worse crisis as bad, if not worse, than the Great Depression of the 1930s. And the pensioners of the world are likely to pay the greatest price.

Global debt still piling up

Total debt ($tn)



Source: Institute of International Finance
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The major nations of the world are swimming in debt. They are in fact mortgaging the future earnings of their children to meet present costs. Taking South Africa as an example, the Government currently spends 60 percent of its tax income on the "Social Wage"; that is on social grants and health services and 40 percent on the public service wage bill.

For everything else it does, the South African Government has to resort to borrowing.....and every year the social wage rises at a faster rate than tax revenue which guarantees that our indebtedness will continue growing and already, as my next graph shows, our Government debt amounts to 53.1 percent of Gross Domestic Product: up from 51.6 percent last year and 27.8 percent a decade ago.

Latest estimates, furthermore, suggest that as early as next year we could reach a debt level of 60 percent at which stage it is likely, depending upon what interest rate we will have to pay in order to keep on borrowing, the government's entire income will have to go simply to service our debt. And South Africa is one of the world's least-indebted governments! At that stage we would in effect have to hand over our financial affairs to the supervision of the International Monetary Fund.

Here is a list of the 16 governments with debt of over 100 percent of their Gross National Product.

Country	Public debt as % of GDP (CIA)[1]	Date	Total (Gross) government debt as % of GDP (IMF)
Japan	234.7	2016	237.918
Greece	181.6	2016	158.546
Jamaica	130.1	2016	146.591
Lebanon	132.5	2016	139.527
Italy	132.5	2016	126.978
Eritrea	119.8	2016	125.785
Portugal	126.2	2016	122.985
Ireland	77.9	2016	117.122
Grenada	110.0	2012	112.567
Cape Verde	116.8	2016	112.199
Singapore	110.5	2016	111.017
Bhutan	30.0	2016	107.511
Cyprus	104.6	2016	107.106
United States	73.8	2016	106.71
Belgium	106.7	2016	105.600
Barbados	108.9	2016	100.351

To understand what this means, a nation's Gross National Product is the sum of all the earnings of all of the people and all of the companies at work in that country.

Thus, for example, if every citizen of Barbados and every business operating there sacrificed their entire income for a year they would nearly be able to pay off that debt.

Similarly Japan, whose indebtedness is 237.9 percent of GDP, would need all of its citizens and all of its businesses to sacrifice their entire income for two and a third years just to settle their Government's debts.

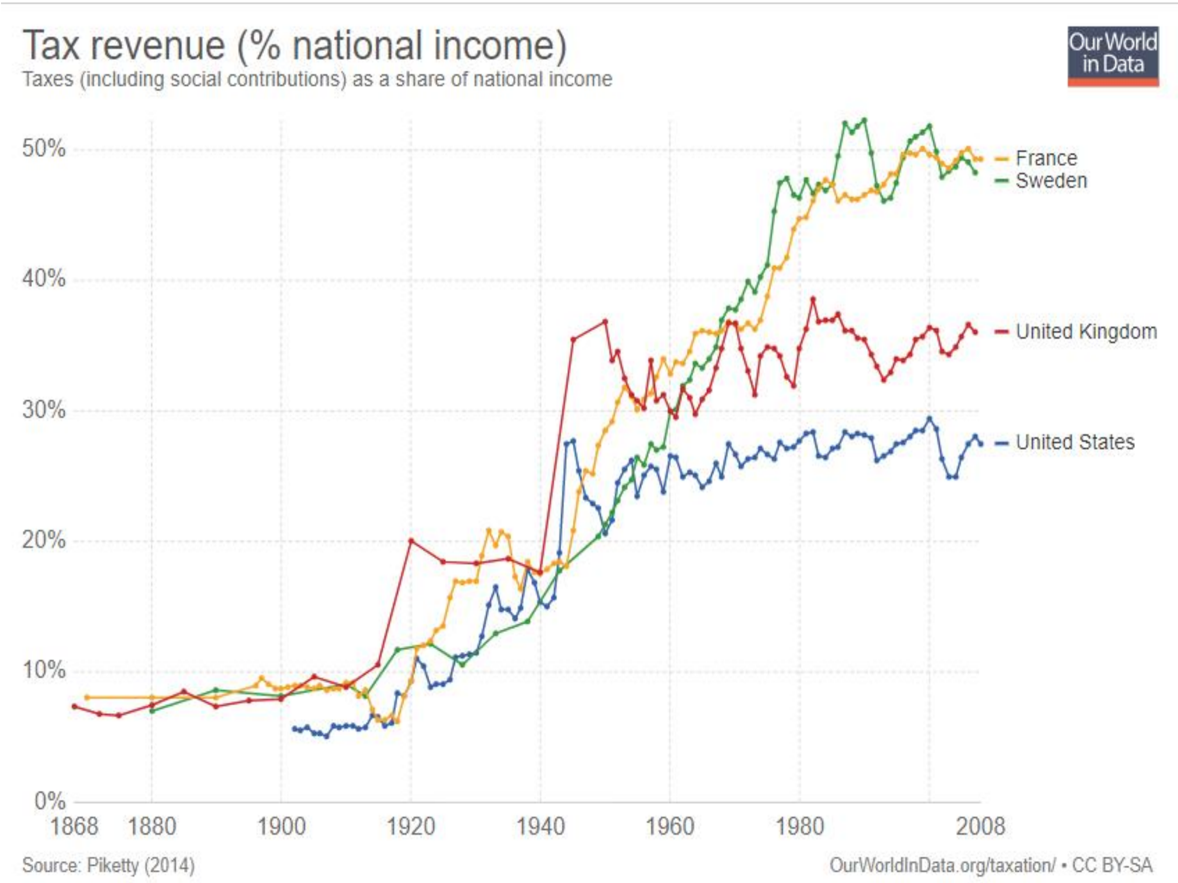
Well that is just not going to happen is it? Part of the problem is that there are a lot of people out there with their hands out and very few with enough to share. In South Africa 3.3 million people pay 99 percent of all the income taxes. Meanwhile, out of a total population of 55-million, 30 million are recipients of grants. And it is not particularly different elsewhere in the world.

Almost all of their governments are operating in deficit, providing social services by borrowing in the sovereign debt market. That is why in United States President Donald Trump was, during 2017, trying to repeal “Obama Care” because he had recognised that US taxpayers could not afford the burden.

Meanwhile in Britain the Government had just announced that all people in their twenties would expect to work until the age of 70 as the state pension rose to cope with an ageing population and longer life spans.

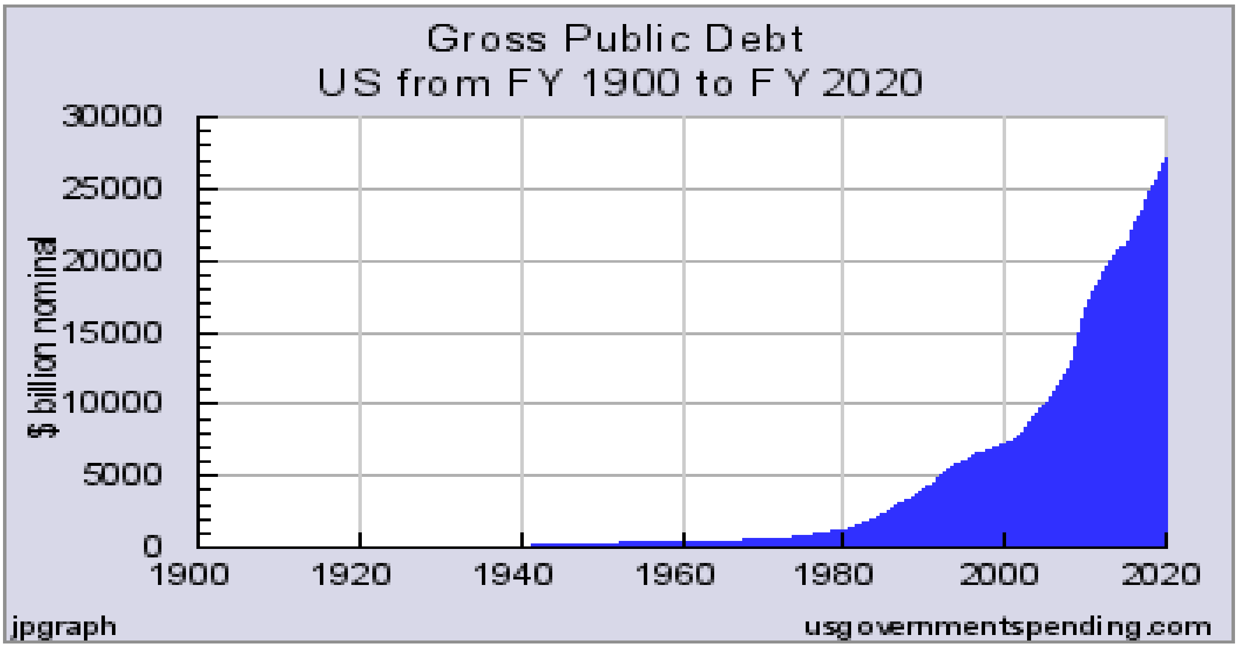
Democracy, as a concept which believes the state should guarantee that every citizen is equal and entitled to certain basic rights such as a roof over his head and an adequate supply of food, simply will not be able to sustain such numbers. As a concept it will have collapsed, long before our grandchildren retire. But what will replace it; dictatorships, and totalitarian states? Your guess is as good as mine but it is likely that the gated estates we now live in will have become walled-off skyscraper cities with private armies to protect those wealthy enough to afford to live within them.

Lest there be any doubt about that, consider the following graph:

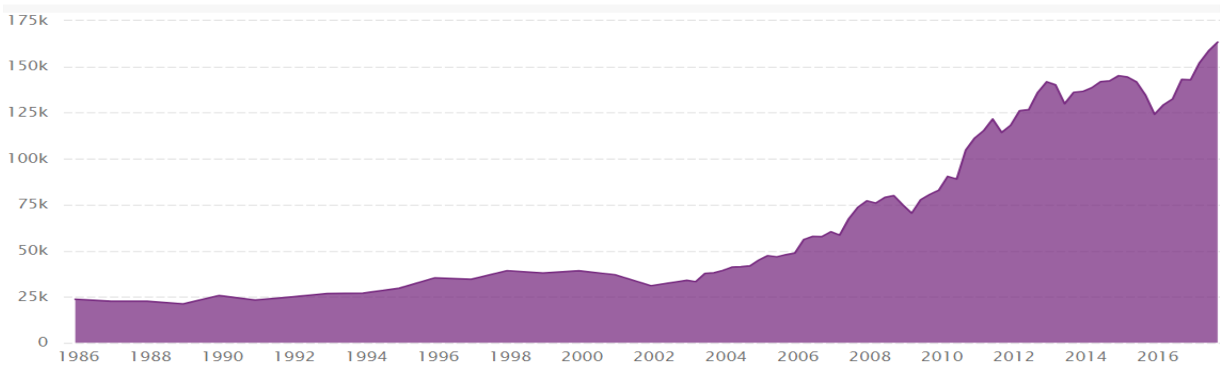


Year after year Governments of the world have steadily increased the taxes they have gathered from their people to the extent that most studies show that it is impossible to collect more. The graph vividly illustrates how, over the past two centuries, governments the world over have squeezed their citizenry with ever-higher tax demands to the extent that the point of taxpayer exhaustion was reached sometime in the 1980s when the graph traces flatten out at approximately the 40 percent level in Britain, 60 percent in France and Sweden and 30 percent in the USA.

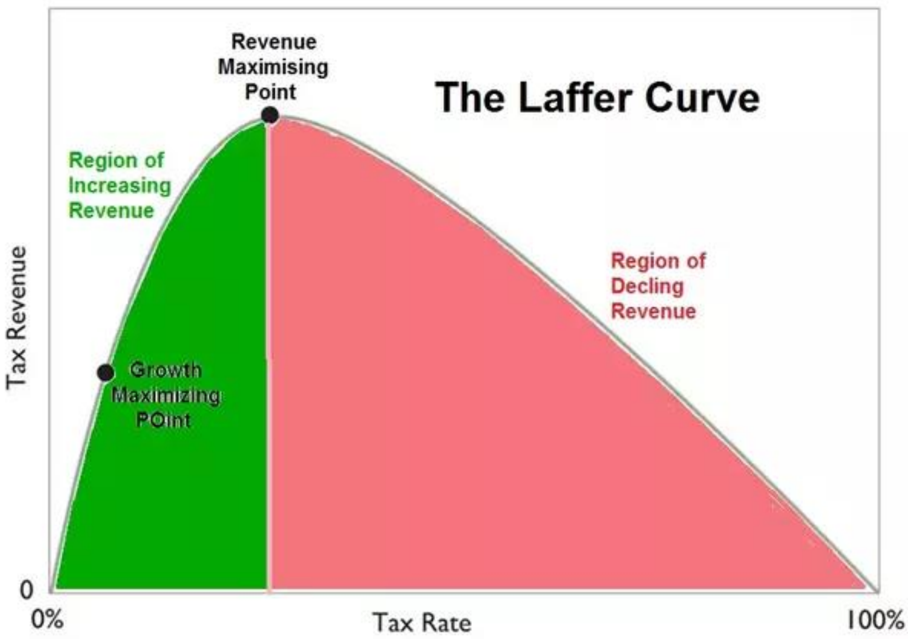
Thereafter they had to resort to borrowing as my next graph illustrates. Here I depict how US government debt soared from 1980 onwards once taxpayer exhaustion had occurred when the taxes collected there reached just less that 30 percent of national income.



And South Africa has been no different. My next graph illustrates how our foreign debt has grown seven-fold since the 1980s.



To understand the concept of tax payer exhaustion I need to turn to the work of economist Arthur Laffer which suggests that as tax rates increase from low levels the revenues collected will increase until at some point further tax rate increases will actually lead to lower tax revenues as the disincentive effects of higher taxes begin to dominate.



While Laffer's primary objective was to illustrate the relationship between taxes and production (i.e. that taxing any economic activity results in less of that economic activity and resultantly lower tax revenues), the Laffer curve also illustrates that higher tax rates result in a greater incentive for tax avoidance and evasion which could also cause tax revenues to fall.

Tax systems do not operate in a vacuum. They are impacted by the social, economic, and political environment in which they operate. Where taxpayers perceive a government to be corrupt, inefficient and wasteful, not delivering benefits to taxpayers or the broader citizenry or a country is in tough economic times, this will result in the Laffer curve shifting downwards and to the left.

The evidence emanating from South Africa's 2018 Budget suggests South Africa was a relatively late comer to this phenomenon but it has now maximised the tax revenues that it can extract from its citizens and has possibly even gone past that point and is now on the downward slope of the curve. That is why there was a R51-billion shortfall in the budget.

So how did we get there? Tax revenue doubled in the ten years to 2018, according to data from the South African Revenue Service (SARS). According to SARS's head of revenue and research, Randall Carolissen, personal income tax had been the biggest contributor since the 2008-09 financial crisis.

Revenue increased from R572.8bn in 2007-08 to R1.144-trillion in 2016-17, up R571.3bn. In this period, the total revenue collected was R8.13-trillion while revenue from personal income tax increased from 29.6% in 2007-08 to 37.2% in 2016-17.

In the 2017 medium-term budget policy statement, then Finance Minister Malusi Gigaba estimated the tax revenue deficit to be R50.8bn in 2017-18; that is the highest deficit since the 2009 recession. The budget deficit was also projected to widen from 3.1% to 4.3% of GDP.

So it was crunch time for South Africa. The latest tax increases, if the widely accepted Laffer studies are correct, will NOT produce the required revenue and we have exhausted our borrowing capacity.

Like governments all over the world, South Africa has to face up to the fact that in future it will have to live within its budget. But does it intend doing so? Ominously, Parliament had just passed a new law allowing the government to expropriate without compensation any property of its citizens and, despite a nationwide canvass of public opinion that showed two thirds of South Africans are opposed to a constitutional change to facilitate such expropriations, the ANC has put its election future on the line in order to steam-roll it through Parliament.

Where might it end? Unable to tax their people further and having exhausted their borrowing capacity, is the world beginning to enter a new phase in which it arbitrarily confiscates the assets of its citizens in order to continue pursuing policies which do not necessarily accord with the best interests of everyone?

South Africa is, as I have already illustrated, not alone in this dilemma. Most of the world's major nations have taxed their people to the limit and borrowed to the limit…and still they continue borrowing.

Where you, my readers come in is who are the lenders? And the answer, of course, is you are. If you are a pensioner or if you are currently contributing to a pension fund then it is highly likely that approximately a third of the money in your pension fund is invested in government loan stock and it is contributing approximately two thirds of your pension income. It is that way because most world governments require the funds of their pensioners to be so invested.

So the message is very clear. If your sole source of income is a pension, you need with some urgency to plan how you can reduce that dependency!

Conversations are key to preserving wealth through the generations

By Patrick Lawlor
Investec Private Wealth

"From clogs to clogs in three generations" is an old saying that has been proven to be true over the years. Research has shown that 70% of wealthy families lose their wealth by the second generation and 90% by the third.

This is also borne out by surveys showing that the list of the UK's 1000 wealthiest families and individuals is a "revolving door" ("The Sunday Times Rich List", April 2017).

The old saying has stood the test of time with the growing complexity in tax, estate planning, and exchange controls. These add to the list of potential pitfalls that end up eroding the passage of wealth management between generations.

Generations and siblings of wealthy families are nowadays also more likely to find themselves spread out across different countries, with regulation in different jurisdictions adding to the complexity, while the structure of families themselves is changing: second marriages mean second groups of children.

So how does a family ensure that wealth is not lost over the generations? This and other questions were top of mind for Investec clients who recently attended our series of In Conversation events around the country, with the theme of intergenerational wealth planning.

The event was an Investec One Place collaboration between Investec Private Banking and Investec Wealth & Investment, with large numbers of Investec's high net worth clients in attendance. Our panel included Investec Wealth & Investment 's joint heads of Wealth Management, Alexandra Nortier and Marc Romberg, and Rene van Zyl and Lizzie Fick, of the fiduciary and tax team at Investec Wealth & Investment.

Perhaps apt for the "In Conversation theme", all of the panelists stressed the importance of families having meaningful conversations about wealth planning and management, starting as early as possible. According to Alexandra Nortier: "What we've found is that that the families who transfer wealth positively are the ones who start the conversation [about wealth] early. They educate and they mentor."

Marc Romberg spells out some of the reasons wealth doesn't make it to the third generation. One reason is simply fragmentation: the inheritance is spread out across a broad range of heirs. Poor returns on investments or a lack of interest by heirs in managing the family wealth are others. Stewards of the family wealth may end up taking excessive risks or, alternatively, invest in very low-risk investments and find the wealth being eroded by inflation. Poor tax planning can also erode wealth, while conflict can lead to poor decisions.

"But the lack of strategic planning, mainly around succession planning, is perhaps the main reason," argues Romberg. This requires open conversation between family members as a start.

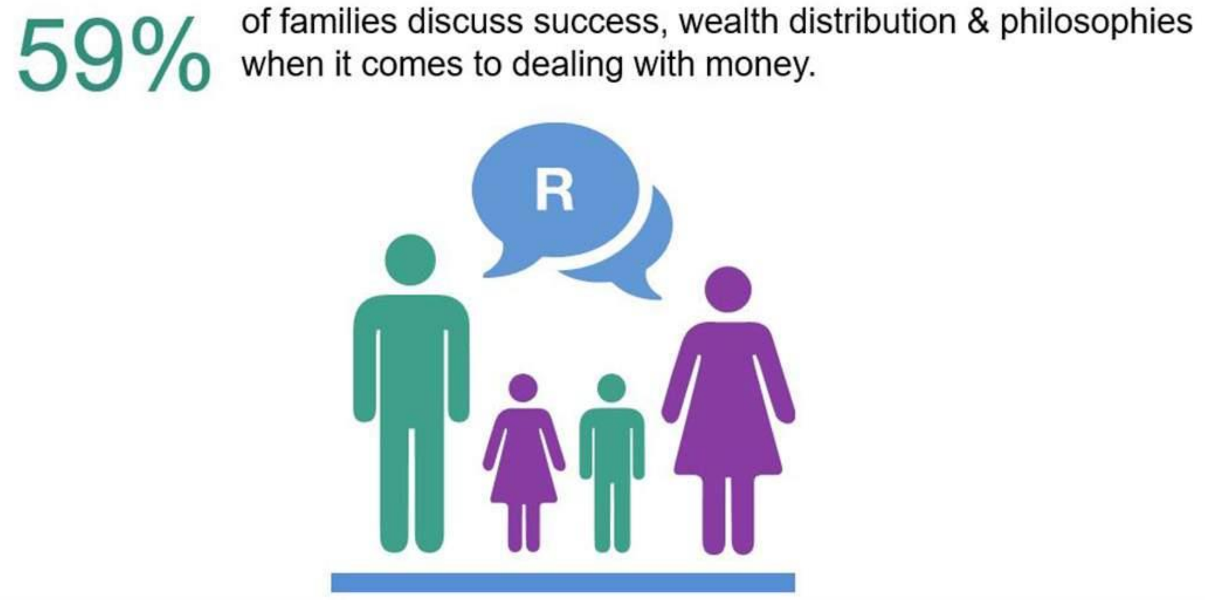
With this idea of keeping the conversation going, at each event we surveyed the audience on a number of key questions around intergenerational wealth planning. The survey was done by pressing keys on a small device on their seats, ensuring anonymity and instant results. A total of 1331 Investec clients at seven different events participated in the survey, and there were some interesting results. We show these results below, with the panellists' commentary following each.

What is more important to you?

A) Ensuring your heirs are better off? 76%

B) Contributing to your community, society at large, or the environment? 24%

It's clear our clients are keen to leave their heirs in a comfortable position, but there is also a keenness to contribute to making the world a better place. This imperative may grow in future years, especially in the light of worries about global warming, poverty and biodiversity. Romberg points out that for Millennials and Generation Z (those born in the early 1980s and later), "It's not just about financial profits, so we are likely to see greater focus on impact investing from here on."



But the two goals need not be mutually exclusive. With proper planning, a wealthy family should be able to serve both imperatives.

Do you have family discussions around succession, wealth distribution and philosophies when it comes to dealing with money?

a) Yes 59%

b) No 41%

How prepared do you feel you are to transfer your wealth to the next generation?

a) Very 21%

b) Moderately 41%

c) Slightly 24%

d) Not at all 14%

The above questions deal with some of the structures and agreements that families put together to manage their wealth. A well-drafted will is an obvious starting point, but as well as being up-to-date, a will needs to take into account the different tax regimes where assets reside, and any change to legislation in the different jurisdictions (see below for more detail).

Lizzie Fick says trusts are a useful succession planning tool and can be useful in protecting beneficiaries and instilling core values. Nonetheless, trusts do face a number of challenges on the tax front that founders need to be aware of.

Many wealthy families have adopted a family constitution as a way of instilling values and managing conflict. Though a family constitution is a non-binding document that can take many forms, it is a robust way to manage the intergenerational wealth transfer and build consensus around key issues, such as:

- Who runs the family business
- Key ethical and moral issues
- Investment strategies (which can also include ethical issues, such as socially responsible investments)
- The family's philanthropic vision.

"The family constitution can be as detailed and formal as you like, or short and simple, provided it clarifies and supports the family's key philosophies," says Nortier.

What is the current geographic split of your investable asset base (SA vs offshore)?

a) 100% SA investments **20%**

b) 70% SA / 30% offshore **44%**

c) 50% SA / 50% offshore 19%

d) More than 50% offshore 17%

This question not only speaks to the importance of a well-diversified investment portfolio – of which offshore investments are a key component – but also to the challenges of complex modern families and where their assets live.

“Family units are becoming more complex and more international,” says Rene van Zyl, with beneficiaries and assets in different countries. Blended families add to that complexity. Where family members reside and where assets are situated, significantly impact how best to preserve family wealth and this MUST be taken into consideration when drafting a will.”

The once sacred principle of banking-secrecy saw its demise thanks to US Foreign Account Tax Compliance Act (FATCA) and a FATCA-like regulation known as the Common Reporting Standard (CRS). CRS requires automatic reporting between countries on a mutually beneficial basis.

The implementation of the CRS means that SARS, more than likely, will discover any undeclared offshore funds, whether they are held in complex structures or not. They now automatically gain access to financial information relating to SA tax residents’ offshore dealings and their offshore structures.

Situs is Latin for “position” or “site”. On death, South African residents are liable for estate duty based on their worldwide assets. Estate duty is currently levied at a rate of 20% in the case of an estate less than R30m, and at a rate of 25% on the value above R30m, but there are also situs taxes levied in the US, UK and elsewhere for assets held there. “It’s vital that the executor understands the different requirements in different countries,” says van Zyl. Also important is for families to plan accordingly and to get the right advice when it comes to intergenerational wealth management.

“It’s really important to have a family roadmap to deal with all of the tax and estate planning complexities,” says Lizzie Fick. “A family constitution, along with well-drafted wills and trusts that take into account all of the legal possibilities, are essential.”

Do I Need a Budget?

By Jared Dillian

Probably not.

Eh.

I am a bit like the Joker. Do I look like a guy with a plan?

The problem with plans is that people interpret them a little too rigidly. I know of a situation where a woman budgeted ***x*** for groceries, and her bill at the checkout line came to ***x*** + $20. She stood there and said "I can't afford my groceries" because she went over her budget by $20. True story.

That is the type of stupid stuff that happens when you put people on a budget.

The problem is, some people need to obey stupid rules, because they have zero discipline. Unless they follow a budget to the penny, they are going to spend like sailors. I am sorry that these people exist. As many others have observed before me, rules are for the stupid.

Even though I am not high on budgets, I am high on radical saving, so I like a simple heuristic such as ***save as much as humanly possible*** or ***save until it hurts.*** That usually does a better job than an actual budget, and is a lot less work. Of course, that works for me because saving comes naturally to me in the first place, so it might not work for everyone.

What does ***saving until it hurts*** look like in practice?

You are driving down the road. You are thirsty. You think of stopping at Burger King and getting a large Diet Coke, but you are saving as much as humanly possible, so you don't spend the $2.50 and you keep driving, and you stay thirsty.

Basically, if you are saving as much as humanly possible, you will experience discomfort. Physical discomfort. That is when you know you are doing it right.

You will go to a restaurant and get the cheapest thing on the menu, whether you like it or not. That is mild discomfort.

You will go to Dick's Sporting Goods for a pair of running shoes and get the $39 shoes instead of the $129 shoes. That is mild discomfort.

You will buy a gently used car that is one year old rather than a new car. No new car smell. That is mild discomfort.

The goal is to save and save and save so you can reach a point where you no longer have to experience discomfort. If you are thirsty, you can buy the Diet Coke. The $2.50 will not be a big deal.

I can speak from experience—it is nice when you get there. But I was once forced to make those economic choices.

Some People Don't like Discomfort

Some people are never willing to make any sort of economic sacrifice. Hey, a wine fridge sounds like a good idea. Hey, the panoramic sunroof sounds like a good idea.

My story is one of economic sacrifices. I lived far below my means during a time when it was expected I would live far above my means. When I was at Lehman Brothers, I bought a tiny, cheap house in a neighbourhood that was not even really up-and-coming. I famously bought Men's Wearhouse suits. I brought cans of Chef Boyardee to work for lunch. I was comically miserly.

Interestingly, it ended up being necessary. Lehman went bankrupt, my stock vaporized, my income disappeared, and I had to start from zero. But I had a seven-figure bank account from what I had saved in the good years, and that meant I was able to take risk—at a point in time where nobody was in the mood to take risk.

Dave Ramsey has an expression for this: "Live like no one else, so you can live like no one else." I have my disagreements with Mr. Ramsey but I like this turn of phrase.

At the Same Time

You can't spend your whole life in doomsday-prepping mode. I have some relatives who were prodigious savers all their lives, never allowing themselves any extravagance, and they are now too old and physically infirm to enjoy their wealth.

There are two types of people in this world: people who spend too much, and people who spend too little. Sometimes, the latter are even more frustrating than the former.

Some people say that budgets give people good habits. I am not so sure. Budgets are good for people who follow rules.

But what if there are no rules? There are no rules in life. If you make more money, are you going to change the rules, to allow the occasional extravagance? Who gets to change the rules? If you change the rules, are you cheating on the budget?

This is why I hate budgets.

Some people inherit a ton of money and never spend a minute of their lives in discomfort. That does not apply to most of us. Unless you are blessed with unlimited resources, you are going to spend at least some of your life in a state of discomfort.

Better to do it while you are young, when you are better able to bear it.

Our pessimism is our problem

By Chris Hattingh

Discovery CEO Adrian Gore mentioned at the recent Leadership Summit that there is an element of "declinism" — a pessimism about the state of one's country — in South Africa, and that it did not accurately represent the situation facing our country.

While Gore might be correct that some things are improving, it cannot be denied that we are on a downward slope, and that if we continue to follow our current trajectory, there won't be anything left to transform.

Speaking at the Free Market Foundation on 31 October, economist Dawie Roodt laid bare SA's current fiscal situation and pointed out that, according to the Treasury, our GDP is expected to grow by only about 1.7% in 2019. Compared to emerging economies which invest an average 23% of GDP, SA's fixed investment percentage is only 19%.

As a percentage of total GDP, the government spends 29% on political vanity projects, for which we simply do not have the fiscal room — the National Health

Insurance being one example — are planned and all they ever result in is increased bureaucracy, increased government size, and ultimately lower growth.
According to economist Njabulo Mhlambi, the public sector wage bill stands at about R328,000 per civil servant per year on average. This R587-billion per year for over 2 million bureaucrats and officials and it represents almost a third of the budget.
It was thus heartening that during his election campaign within the ANC, President Cyril Ramaphosa promised to cut back on the size of government. Finance minister Tito Mboweni also recently alluded to the idea of reducing the size of Cabinet from an astonishing 70 ministers down to 25 or ideally 20. But at the Jobs Summit held on 4 and 5 October, Ramaphosa announced a moratorium on public sector job losses. If the President intends to stick to this moratorium, it will be a grave mistake.

Many civil servants, with respect, work in fields and areas that are not important to SA's immediate development. Practically everyone working in the sports, arts and culture, and small business development clusters in Cabinet are not producing anything that contributes to economic growth, employment, and prosperity in SA.

Despite making some efforts, the Department of Small Business, for instance, has failed completely to represent the interests of entrepreneurs who cannot afford to comply with government's excessive and ever-growing red tape. It has not been able to restrict in any way the new National Minimum Wage Act, new taxes, and the evermore registration and licensing procedures in telecommunications, transport, and financial services, which have been allowed to be enacted into law and have a detrimental impact on small and medium enterprises.

It is only hubris for the government to think it can have entire State departments dedicated to luxuries like sport and arts and culture at a time when we have less than 2% economic growth and practically no job creation. The taxes that SA's diminishing tax base is providing are being thrown to bureaucracies and vanity projects that we simply cannot afford or sustain.

How do we resolve this situation? Do we go down the same government-focused path of zero growth, or do we opt for something more radical? The solution, thankfully, is simple, and only requires political backbone.

The days of bowing before trade unions and big businesses clamouring for favours and protections need to end. The market is not intimidated by government or any movement and will wreck any country that attempts to defy basic economic truths. We can only hope that government finds the strength to harmonise its conduct with the reality of economics, rather than attempt to defy it.

Government must start by unbundling and privatising, or liquidating and closing down, all our major State-owned enterprises, like South African Airways and Eskom. Perhaps this can be done by giving all South Africans equal, freely-tradable shares in these enterprises. Air transport and electricity generation and distribution will be provided far more effectively by the private sector. It is imperative that the inefficient, and often-corrupt, hands of government be taken off the steering wheels of businesses that must be profit-driven.

The next thing government must do is repeal draconian provisions in our labour law, and allow the unemployed to get jobs without having to adhere to frequent unmeetable legal requirements. Labour laws make it expensive and difficult for people to trade with each other. The unemployed have to overcome barrier after barrier to find work. Businesses cannot employ more people as long as they have to carry such a burden of onerous legislation.

Thirdly, there must be a wholesale and comprehensive review and repeal of regulations in every field where government has decided to involve itself. The President must instruct all his ministers that for each new regulation they propose to introduce, two substantive regulations must be repealed.

Lastly, government must allow people to save money.

Roodt made the critical point that to grow an economy, you need to postpone consumption, meaning you need to encourage savings, which will lead to capital investment and consequently growth. If SA wants to reach the growth level of other quickly emerging economies, we would need to invest around R200 billion annually.

But people cannot save money if their small surpluses are swallowed up by inflated food and fuel prices that are the consequence of government interference in the market. Government must lower, or better yet, abolish onerous taxes. A moratorium must be placed on the introduction of any new tax, and the Pavlovian taxes which are never utilised for their intended purposes, like sugar taxes, plastic bag taxes, or the fuel levy, must be scrapped.

There are many faux radical political movements in SA that promise change. All of them, however, propose to do more of the same: grow government even more, and take even more money from South Africans. That is not radical. Radicalness means embracing a free market, individual freedom, and a servant — as opposed to paternalistic — State apparatus.

- ***Chris Hattingh is a researcher at the Free Market Foundation.***

Things are bad and getting worse, or are they? The case for positive leadership

By Discovery CEO Adrian Gore

I am known for repeatedly making the call for positive leadership, to liberate our country's incredible potential. What fascinates me, is the criticism I receive for my naivety, given the challenges we face.

I am not discounting the fact we face real challenges, we do: GDP growth is at -0.7%; 50% of those aged 15-35 are jobless; we have a bloated public-sector wage bill and a hefty budget deficit to fill; and tragic inequality. My plea for positivity is not in spite of these challenges, but because of them – and it is rooted in cold, hard science.

The optimism paradox – the gap between private hope and public despair – is an intriguing idiosyncrasy explained by behavioural economics. On the one hand is our belief, that in our personal lives, our future will be better than our past, known as the

optimism bias. According to recent research from the Nobel Prize-winning economist Angus Deaton, based on data collected on 1.7 million individuals across 166 countries from 2006 to 2016, individuals are unwaveringly hopeful – to the point of consistently but irrationally believing they will be better off five years from now.
The optimism bias can be explained by evolutionary biology. With our earliest ancestors facing threats posed by violence, disease, child birth and so on, the average lifespan was 21-35 years. To make any kind of progress in life we needed to imagine a reality that was different, and one we believed was possible. We are in essence, descendants of the optimists – the pessimists died off.

Counter-intuitively however, this private optimism is contrasted to a persistent and pervasive public pessimism, known as declinism – the belief that our world (or country) is on an irreversible downhill trajectory. Declinism too has its roots in evolutionary biology. Hunter gatherers were faced by constant environmental threats and were coded to seek out negative cues, a fundamental conditioning for survival.

Last year, the global market and opinion research organisation Ipsos MORI surveyed perceptions of 26,489 people across 28 countries as to how the world is changing. 62% of respondents believe the world is getting worse, fuelled by misperceptions of how the world has changed. The degree of optimism about the future differed hugely by the level of people's knowledge about global development – those that were most pessimistic about the future tended to have the least basic knowledge on how the world has changed for the better.

The major flaw in much of the declinist narrative is the failure to distinguish between absolute and relative changes: relative decline is interpreted as absolute decline. Steven Pinker highlights these conclusively progressive trends in his latest book *Enlightenment Now*. Life expectancy is up, from a world average of less than 30 years in the mid-18th century to over 70 years today; the threat of infectious disease has been greatly reduced; and around the world, children are going to school longer, and literacy is on the rise. The list goes on.

The critical point is that as South Africans, we suffer this acutely. Not only are South Africans gloomy about how the world has changed and what the future holds; on a broad range of issues, South African survey respondents gave the least accurate guesses of where the figures on global and national development stood – out of all 28 countries. And while South Africans are not just impervious to the facts on progress, the study revealed they are confident in their erroneous perceptions.
Declinism could easily be excused as a peculiarity of cognition, except, it has real and dangerous consequences which impede our progress.

Firstly, we don't see our country's progress. The fact is, South Africa, like the world, is a fundamentally better place as time progresses. Our GDP is 2.5 times the size it was in 1994 on a dollar basis; formal housing has increased by 131% from 1996 to 2016; new HIV infections are down 60% from 1999-2016; and the murder rate per 100,000 is down 50% from 1994 to 2017.

Our country is also larger and more relevant than we think. Our provinces square up against other countries in terms of GDP: Gauteng is bigger than Kenya and Ethiopia, and the Western Cape is almost the size of Ghana. Our economy is substantial: in terms of stocks traded in 2017 (USD bn), South Africa trumps the Middle East and North Africa region, Singapore and Norway; and holds 82% of the pension fund assets in Africa, 18 times that of its second ranked peer, Nigeria. This is in spite of Nigeria's GDP being larger than our own and their population being 3.4 times larger than ours. This is important structurally, these long-term savings are invested into government and corporate debt and company equity, driving growth. Our market also enables massive companies to be built. Discovery's revenue footprint (including Discovery Health Medical Scheme) is more than half that of Mauritius; and both Standard Bank and FirstRand are bigger than all Nigerian banks combined on a tier 1 capital basis.

Secondly, we see problems as insoluble anomalies, and our decline as inevitable. What blinds us from recognising our progress is our myopic obsession with the problem of the day. Pre-2005, the issue was HIV/AIDS. Then we experienced crime in the early 2000s; followed by xenophobia in 2008, and the Eskom power crisis and labour unrest thereafter.

In the past two years – Fees Must Fall, State Capture and land expropriation have occupied the public's attention as the issues signalling our impending demise. It is precisely because these problems change, that they cannot be intractable. I'm not minimising these problems, they are tragic and need to be solved. I'm making the point that we have the ability to gain traction on these issues, albeit at times in a messy way. The effect of the above is that we start perceiving our country and its economy as risky; and we avoid investing, when the opposite should be the case.

South Africa has a relatively stable economy, as seen by its GDP growth which is the lowest in volatility when compared against BRIC peers over 1994-2017. This suggests that we misprice risk and miss opportunities. Although the Rand is one of the most volatile currencies among the same peer set, over the same period. If we consider the country as a 'company', we can then use GDP as a proxy for the 'revenue' of the country, and the currency exchange rate as an indicator for the 'share price'. If we then take the standard deviation of our currency over the standard deviation of our GDP – South Africa has the consistently highest ratio over time relative to the above cohort. This suggests a profound gap between perceived risk and real risk.

Our country has remarkable potential, but we need to deliver economic growth – vital to addressing our serious challenges of unemployment, poverty and inequality – and to delivering real improvements to quality of life. Looking back, had South Africa mirrored the rate of global or emerging market GDP growth, we could have been 17% or 38% bigger (respectively). The Bureau for Economic Research puts the cost of the last ten years at R500 billion, and the opportunity cost at 2.5 million additional jobs. Our rudimentary calculations show this could have had the dramatic effect of halving poverty.

We have a choice: a problem-centric leadership approach as per the above, which perpetuates declinism; or a vision-based leadership approach, which is an antidote to declinism. The latter involves acknowledging our country's progress and creating hope; seeing our problems as real, but soluble, and seeking out positive cues alongside negative ones when reading our environment; and recognising the potential of our economy and investing in it. This is how

Navigating the Debt Crisis

By John Mauldin

Science tells us energy can neither be created nor destroyed within a closed system. Whatever amount is there will stay the same, though it might change form. If only the same were true for debt.

Within the closed system called Earth, we are much better at creating debt than eliminating it. But when we have too much, we eventually eliminate it in painful and unpleasant ways via some kind of debt crisis. This has happened over and over again throughout history.

Today we'll look at a new book by Ray Dalio called ***Principles for Navigating Big Debt Crises*** in which he examines those debt cycles and what we can do about them. I read it on my recent trip to Frankfurt and I highly recommend you do the same. That link is for Amazon but you can also get a free PDF copy here. I read it on my Kindle so I could highlight and save notes in the cloud for later reference. Worth every penny of the $14.99 I spent.

At a minimum, you should read the first 60 pages, which explain his principles and thoughts. The rest of the book dives deep in the weeds of 48 modern debt crises, sorting them into different types and then analyzing each type. Data wonks will love that part. Ray gives us a brilliant ***tour de force*** examination of how debt crises arise and what you can do when one strikes.

At first blush, you will think that Ray is more optimistic than I am about the next debt crisis and an eventual event which I called The Great Reset, which I've written about extensively this year. I see The Great Reset as a generation-scarring economic cataclysm. Debt crises, while painful, have a fundamentally different character.

Ray's book has helped me refine what I mean by The Great Reset. We'll explore this more in future letters but here is one very important, critical, point:

It is possible we will have another debt crisis separate from The Great Reset I envision. Indeed, it may be quite likely.

In one sense, what we called the "Great Recession" was just another garden-variety credit cycle. Unlike the Great Depression, so far it doesn't seem to be changing the behaviour of those who went through it. The Great Depression was a soul-searing, generational-impacting event. The events around 2008, bad as they were, had nowhere near that effect.

In fact, we are now many of the things we did in 2006 and 2007—reaching for yield, etc. It is as if we did not learn that the stove was hot. We are loading up on all sorts of unrated and low-rated credit and even leveraged (!!!) loans to juice returns in a low-rate world, telling ourselves "This Time is Different."

Really, we tell ourselves that. And it never is. Sometimes I sit in awe and amazement at the human capacity for believing Six Impossible Things Before Breakfast. And we do it time and time again, over and over, insanely expecting a different result.

But that is getting ahead of ourselves, so let's start exploring Ray's book.

Know Thyself

Before we get into the book, you should know a little about Ray Dalio and the company he founded, Bridgewater Associates. At $150 billion or so under management, it is one of the world's largest and most successful hedge fund operators. It is also an extremely unusual company.

Dalio decided early in his career, after enduring some painful losses and nearly going bankrupt, to rigorously examine his mistakes. When he was wrong—as all traders sometimes are—he would review his process, identify mistakes and keep a record of them. This helped him avoid making them again.

Eventually he extended this process to his entire company. At Bridgewater, the staff use a computer system to constantly rate each other's decisions, both small and large. The result is a giant database of who tends to be right and on which subjects they are strong and weak. This affects personnel decisions, work assignments and all sorts of other things. It's all transparent, too. Everyone at Bridgewater knows everyone else's business.

Obviously, not everyone thrives in that environment. But over time, it's made Bridgewater into what Ray calls an "idea meritocracy." People who make good decisions get identified and rise to the top.

I tell you all that so you understand Dalio is highly ***empirical***. He doesn't make guesses without evidence, and you see it in this rigorous historical examination of previous debt crises. It was originally an internal Bridgewater study that informed the firm's (very successful) trading of the 2008 crisis. The team examined 48 debt crises over the last century to develop an "archetype" or template showing how they unfold.

Lending Allows Spending

Like me (and many others throughout history), Ray recognizes that debt can be good or bad, depending on how it is used. He goes further with an important insight on the way debt is cyclical. He explains it so well I will quote him at length here (emphasis mine).

> ***To put these complicated matters into very simple terms, you create a cycle virtually anytime you borrow money. Buying something you can't afford*** [out of your capital or cash—JM] ***means spending more than you make. You're not just borrowing from your lender; you are borrowing from your future self. Essentially, you are creating a time in the future in which you will need to spend less than you make so you can pay it back. The pattern of borrowing, spending more than you make, and then having to spend less than you make very quickly resembles a cycle. This is as true for a national economy as it is for an individual. Borrowing money sets a mechanical, predictable series of events into motion.***
>
> ***If you understand the game of Monopoly®, you can pretty well understand how credit cycles work on the level of a whole economy. Early in the game, people have a lot of cash and only a few properties, so it pays to convert your cash into property. As the game progresses and players acquire more and more houses and hotels, more and more cash is needed to pay the rents that are charged when you land on a property that has a lot of them. Some players are forced to sell their property at discounted prices to***

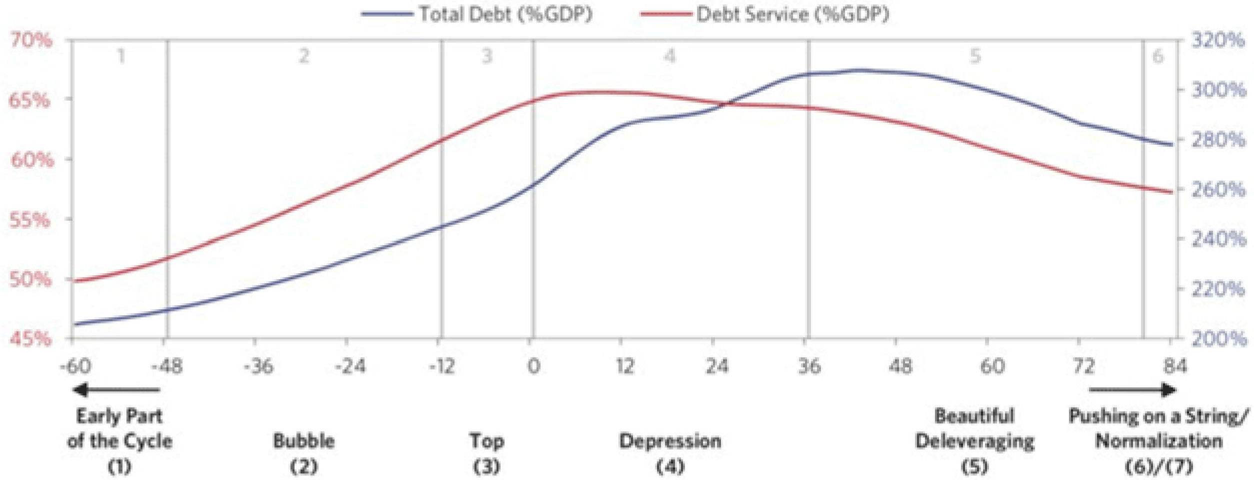
raise that cash. So early in the game, "property is king" and later in the game, "cash is king." Those who play the game best understand how to hold the right mix of property and cash as the game progresses.

Now, let's imagine how this Monopoly® game would work if we allowed the bank to make loans and take deposits. Players would be able to borrow money to buy property, and, rather than holding their cash idly, they would deposit it at the bank to earn interest, which in turn would provide the bank with more money to lend. Let's also imagine that players in this game could buy and sell properties from each other on credit (i.e., by promising to pay back the money with interest at a later date). If Monopoly® were played this way, it would provide an almost perfect model for the way our economy operates. The amount of debt-financed spending on hotels would quickly grow to multiples of the amount of money in existence.

Down the road, the debtors who hold those hotels will become short on the cash they need to pay their rents and service their debt. The bank will also get into trouble as their depositors' rising need for cash will cause them to withdraw it, even as more and more debtors are falling behind on their payments. If nothing is done to intervene, both banks and debtors will go broke and the economy will contract. Over time, as these cycles of expansion and contraction occur repeatedly, the conditions are created for a big, long-term debt crisis.

In other words, debt actually ***creates its own cycles***. Lending (especially from institutions that can create money under a fractional reserve banking system) allows spending that spawns more spending, which eventually must reverse into contraction that spawns more contraction. That may seem obvious but we often forget it. As we apparently have done even as I write.

After examining dozens of debt cycles, Ray's team built this template to describe the six stages of the deflationary variety.



Source: Ray Dalio

Stage 1 is the "good" part. People borrow money, but not too much and they use it for productive purposes. This helps the economy grow and lifts asset prices… which is where things start going wrong.

In Stage 2, which Dalio terms the "Bubble," people look at the recent past and decide asset prices, total demand, and consumption will keep going up. They overconfidently borrow more money and start having too much leverage, although it is never possible to actually define the moment when the right amount becomes "too much."

Stage 3, the "Top," occurs when central banks and regulators and sometimes even the lending institutions themselves see problems and take steps to moderate growth—always thinking they can slow down without braking too hard. They raise interest rates, tighten lending standards, and so on.

Stage 4, ominously called the "Depression," happens when growth slows or reverses beyond the ability of monetary and political authorities to help. Yet they keep trying. This is when we see interest rates go to zero or negative. The central bankers are out of bullets at this point. Everyone just has to suffer.

Stage 5 is the deleveraging phase, when businesses and families reduce spending to pay down debt and reduce their leverage. It can last a long time, but as leverage falls people get a handle on their debt service costs and slowly start to recover. Eventually the economy reaches Stage 6, normalization, and the cycle repeats.

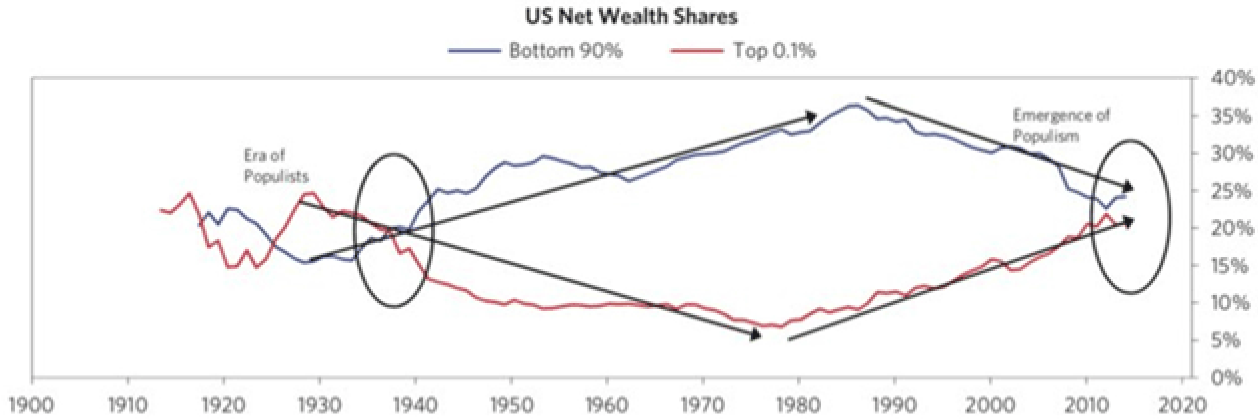
Wealth Gap

So that was the template for a generic debt crisis. Each one has its unique characteristics (he goes into each historical crisis separately in the last sections of his book) but they generally follow this sequence. Which raises the question, where are we now? Dalio thinks we are in the late stages and points to interest rates as evidence.

Source: Ray Dalio

Twice in this century, the US went through debt crises so severe that the Fed had to drop rates to zero and resort to unconventional policies like quantitative easing. The first time was in the 1930s and then again in 2008-2009. In both cases, it "worked" in the sense that asset prices recovered. But it also had adverse side effects because higher asset prices accrue to asset owners, which most people are not, at least to any significant degree.

The result is a wealth gap between rich and poor, which of course always exists, but in these periods it grew too obvious to deny. A small part of society prospers as its assets gain value while the majority struggles. It happened in the Great Depression and we saw it again in the post-Great Recession years. Data-driven Dalio quantifies it in this chart.



Source: Ray Dalio

If that looks familiar, it's because I've showed it and similar charts to you before. Ray originally posted it in a 2017 article which I summarized in a letter called The Distribution of Pain. His main point then was that it is a serious mistake to think you can understand "the" economy because we really have ***two*** economies. The top 40% live in a different world than the bottom 60%.

Combine those conditions of wealth inequality with representative democracy and the result is populism and our currently divided politics. It may become even more so now that Democrats will control the House next year. The result will be legislative gridlock, which isn't entirely bad but may stall policy changes that could help postpone recession.

Already-huge federal deficits will therefore keep growing just as the Federal Reserve both raises rates and reduces its balance sheet assets. So far, this combination hasn't stopped GDP growth or even perceptibly slowed it, but at some point it will. That is the goal, after all, and Ray's template shows it usually succeeds.

In this case, I think the trigger will be a crowding-out effect as Treasury borrowing combined with Fed tightening raises household and corporate debt service costs. Everyone has a breaking point and it is getting closer.

The "seventh-inning stretch," if you don't know the term, is a point near the end of a baseball game. There's enough time left for the trailing team to catch up so no one wants to leave yet. You stand up, stretch, singing "Take Me Out to the Ballgame," then settle back in to see what happens.

That's kind of where we are in the debt cycle: near the end, but not yet sure of the outcome. The difference is that none of us are just spectators. We are all in the game, and we will all either win or lose.

A Beautiful Deleveraging

Ray has been writing over the past few years about what he calls "A Beautiful Deleveraging," when the central bank manages to defuse the debt-burdened economy without a major crisis. Here is what he says:

> ***The key to handling debt crises well lies in policy makers' knowing how to use their levers well and having the authority that they***

need to do so, knowing at what rate per year the burdens will have to be spread out, and who will benefit and who will suffer and in what degree, so that the political and other consequences are acceptable.

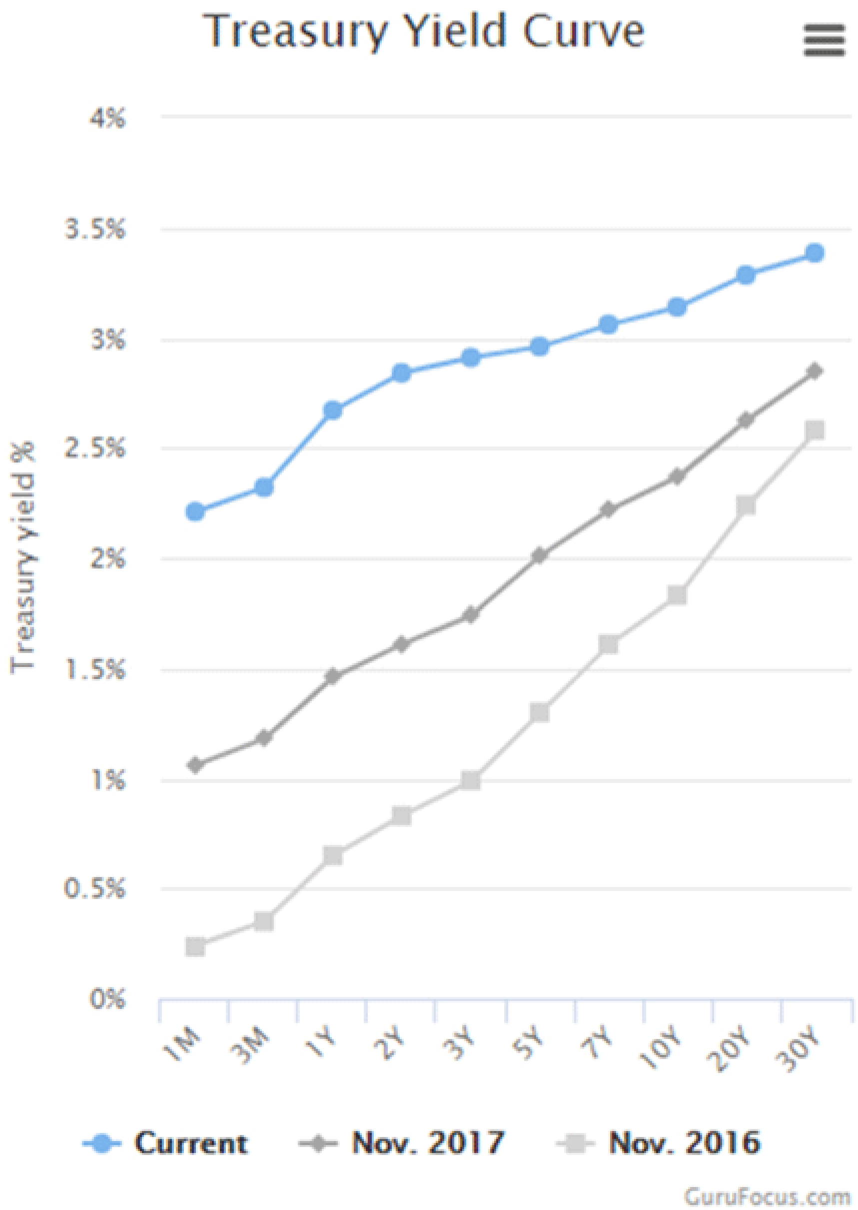
There are four types of levers that policy makers can pull to bring debt and debt service levels down relative to the income and cash flow levels that are required to service them:

> ***1. Austerity (i.e., spending less)***
>
> ***2. Debt defaults/restructurings***
>
> ***3. The central bank "printing money" and making purchases (or providing guarantees)***
>
> ***4. Transfers of money and credit from those who have more than they need to those who have less.***

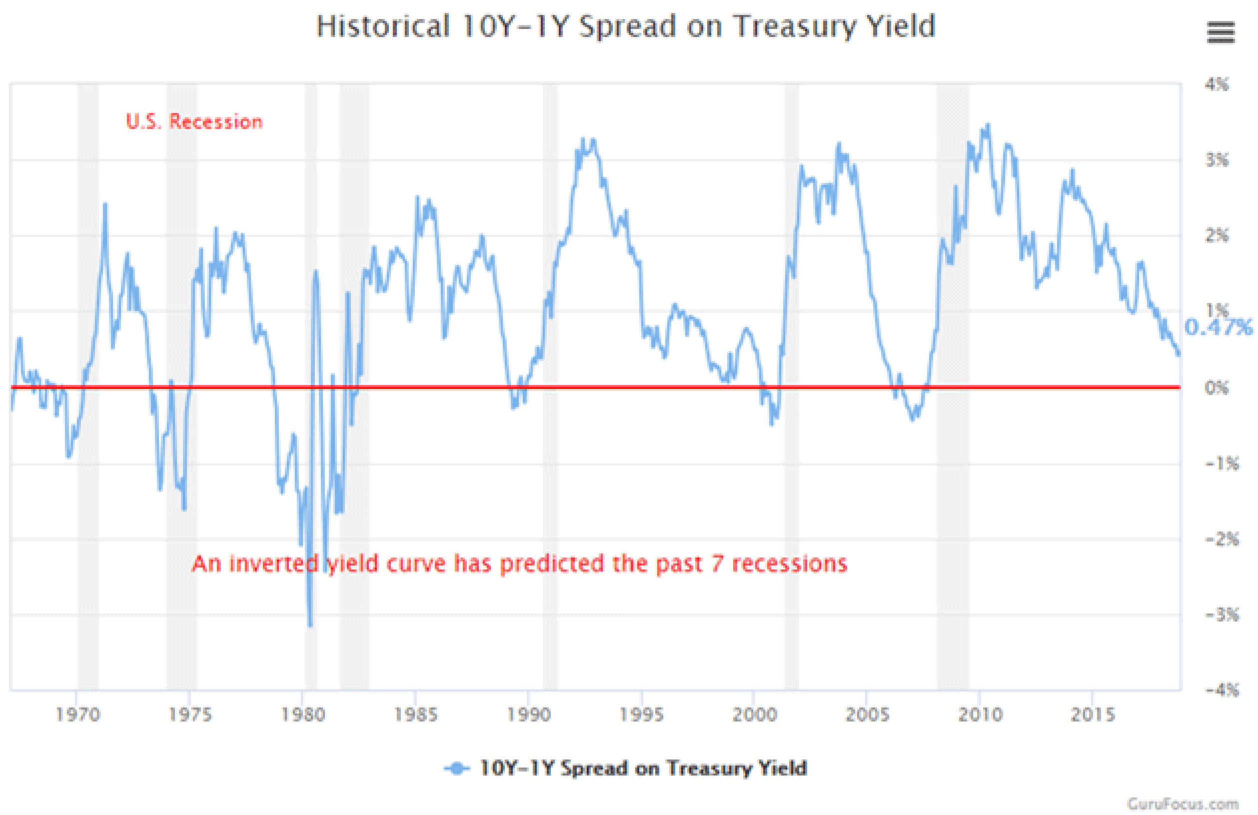
1, 2, and 4 above require varying levels of pain for lenders and borrowers. Number 3 still has pain for all concerned, something like 2008-2014 when the Fed and other central banks around the world bought trillions in assets, but it was likely better than what would have happened absent those policies.

The Federal Reserve is late in the process of raising rates, but under Powell seems committed to reaching what many economists call "the natural rate of interest." My personal belief is that we are close to that point now. If we go past it, then I think the Fed will tip the economy over into a recession. This will be preceded by an inverted yield curve, or the place where short-term government interest rates are higher than long-term US bond rates. Since World War II, this "inverted yield curve" has always preceded a recession by somewhere between 9 and 15 months.

This first chart from GuruFocus shows the yield curve has been "flattening" for the past few years. Below that, you see the historical yield curve spread since 1970. As they note in the chart, this preceded all of the previous seven recessions.



Source: GuruFocus



Source: [GuruFocus]()

I want to be clear that an inverted yield curve does not *cause* **recession. It is a** *symptom* **of imbalances in the banking and financial systems.** Think of it like a fever brought on by a virus. The fever is a result, not the cause of the disease. It tells you something is wrong in your body.

Note that in the graphs above, short-term rates have risen roughly two percentage points while long-term rates rose around one point. We call this a "tightening" of the curve and it is the first step toward inversion. You can bet Fed officials are watching this, as they really don't want the yield curve to invert. *It will not surprise me if, even though they have signalled more rate increases, they actually stop short of their current targets.* Another point higher at the short end would clearly invert the yield curve unless there is a similar rise in long rates, which has not been happening so far.

At that point, you are really going to wish that you had read Ray Dalio's book. Next week we will dive deeper into the process. And just as important, why another credit crisis may happen before we have what I think of as The Great Reset. Stay tuned.