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Time to end this disaster tax

By Richard Cluver

One of the significant differences between my generation and that of our children was that once the children were born our wives gave up formal employment and became home-makers.

I had always imagined it was a matter of choice, greater job opportunities and better education which led to the fact that the great majority of wives of my children's generation are gainfully employed in a myriad of interesting careers. A discussion with my youngest son who works in the rarefied air of Wall Street has put paid to that illusion. For the majority of his friends and associates, the cost of putting a roof over their heads has made it quite impossible to think of wives not working and the consequence can be seen in a declining US birth rate. It is sheer economic necessity and you can blame Capital Gains Taxation for it.

I have frequently written of how CGT has hindered efficient investment because it forces investors to hang on to underperforming investments, but I had never realised how insidious this tax is on a global scale and what damage it is doing in a multitude of areas. Let me start with a simple example:

In days gone by, the big family home was as much a part of retirement planning as it was a repository of happy family life. When the children had grown up, most couples were happy to shed the burden and move to a smaller retirement cottage close to a good fishing ground or some beautiful mountains where the daily commute to the office was but a hazy memory.

But capital gains taxation and profiteering retirement village developers put an end to that one. Many of my friends have discovered to their horror that when the big four-bedroomed home was sold, it did not realise enough to pay for a dolls house in a new gated community.....and that was before the tax man came knocking demanding his share of the proceeds of the sale.

Elsewhere in the world where property values have not suffered from Zuma-induced recession and emigration, intelligent home owners have learned that the only way to treat the family home in one’s retirement years is to rent it out to well-healed tenants. Thus the stock of houses for sale has diminished dramatically and, once regarded as revenue producers in retirement, big family homes have more than retained their value.

Thus in the suburbs of London, New York and Sydney, there is a dearth of houses for sale at affordable prices but plenty available to rent. Why blame Capital Gains Taxation for this? Let me give you an example of the US citizen who 20 years ago received a $250 000 provident fund payout and used the money to buy the house next door as a rental proposition.

The rent provided adequately in his early retirement years but now he is old and would like to go and live with his daughter in Florida where the climate is more benign. The house now has a market value of $1-million having risen in value year by year at a not unusual compound average rate of 7 percent. However, if he sells the property it will attract agents commission of $70 000 together with CGT of $178 500 calculated at a rate of 23.8 percent on the $750 000 difference between what he paid for it and its current value. He would thus be left with only $751 500 of his million dollars...

If he were to invest this sum in treasury bonds at an interest rate of 2.8 percent it would provide him with an annual income of $21 014 compared with his current rental income of $48 000 a year. Furthermore, since he will be moving out of his home in New Jersey he can rent that out as well giving himself another $48 000.

With the proceeds he can afford to rent a condo in Florida or a hacienda in Mexico where rentals are much lower and where domestic help is also considerably cheaper. It’s a no brainer. Why sell the houses when all that Capital Gains Taxation will simply destroy his life savings?

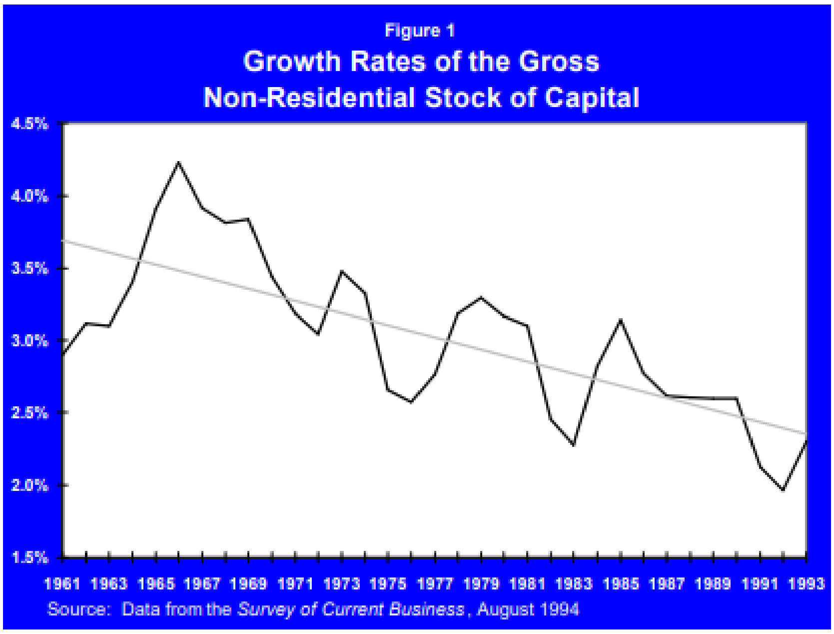
The same scenario is playing itself out in Australia where the government, in the face of a public outcry when the tax was introduced in the 1990s, conceded that there would be no CGT on existing assets. There the smart move is to let the children take over the big family home in Sydney or Melbourne and to rend a flat on the Gold Coast.

And it is playing out wherever CGT has been brought in as a sop to the Socialists who see it as doing something to level the playing fields between rich and poor. The result, however, has been to reduce the supply of housing and thus push up the price of homes for starter families who, by definition, are relatively poor. And, by the way, the US example I cited is a real one and the man involved was a postman; not the kind of occupation which would normally rate one as rich.

So this tax is actually hitting the low-income group worse than it is the wealthy and the irony of it all is that CGT seldom brings in more revenue that it costs to administer. Even here in South Africa where emigration has ensured that house prices have remained low by world standards, CGT is seen as an expensive political ploy which enables politicians to claim they are working towards ending economic inequality.

Worst of all CGT is a retrograde tax that has been shown in case studies all over the world to stunt entrepreneurship and capital growth.

The graph on the right, courtesy of the US Government illustrates the damage CGT has done to capital formation there where growth rates have been falling steadily since the early 1960s.



Here in South Africa, a study by the University of the Witwatersrand School of Economic and Business Sciences, CGT has been shown to be a particular stumbling block in the cause of BEE schemes. The study concluded that “when it comes to these initiatives, the levying of CGT could be tantamount to the State's offering a measure of assistance with the one hand, and then retracting part of it with the other through the application of additional tax.

It adds,” In the long run, CGT may, paradoxically, amount to a double tax that undermines the state's revenue collection, to the detriment of the poor. Rather than being heralded as a success, CGT has, therefore, been lambasted for stifling innovation and entrepreneurship.”

Small businesses are frequently defined as the cornerstone of economies, but the South African Chamber of Business has condemned CGT as having adverse implications for entrepreneurship and job creation. Citing France, Germany and Italy as examples, it was argued that the South African government's decision to levy CGT on small businesses was a possible contradiction of its stated objective of tax equity aimed at combating poverty

It added;" Three aspects of CGT were examined as primary examples of government's drive to tackle poverty in South Africa: the taxing of BEE schemes, the taxing of PBOs and clubs, and the taxing of small businesses. The correspondence analysis has shown that, in each of these areas, there may be potential sources of tax-based unfairness. The analysis has indicated that the levying of CGT on BEE schemes, clubs, PBOs and small businesses has, at least, some correlation with double tax, an unfair charge for state services, and a failure to adequately uplift the poor. The study has, therefore, demonstrated an inconsistency between the official policy of ensuring reform of the tax system based on the tenets of fairness.

A study by Federal Reserve of Bank of Minneapolis in the USA found that entrepreneurship is damaged by the tax. Historically entrepreneurs create new businesses and, once up and running, tend to sell them in order to pursue new start-ups. This process is, however, significantly damaged by CGT with the result that the businesses tend not to be sold on to the type of management that could ensure sustainability….loss of entrepreneurship to the nation.

A Study by the National Bureau of Economic research in the US has shown that the benefit of lowering CGT tax rates results in higher rates of tax revenue while Canada's Fraser Institute has found that "Capital gains taxes, like all forms of taxation, raise revenues for the government but also impose economic costs. Unfortunately, the cost of capital gains taxes is not limited to the amount of tax collected.

"Capital gains taxes impose additional costs on the economy because they reduce returns on investment and, thereby, cause individuals and businesses to alter their behavior. As a result, capital gains taxes have a substantial impact on the reallocation of capital, the stock of capital, and the level of entrepreneurship in Canada. Capital gains taxes significantly impede the reallocation of capital from older, less profitable, investments to those with higher rates of return.

"Numerous academic studies have found that investors do indeed lock in their capital in the presence of capital gains taxes and that the "lock-in effect" significantly impedes economic growth. Without the efficient flow of capital, the development of new, potentially profitable, businesses is limited. Given that these new ventures are the engines of productivity, employment, and wealth-creation, capital gains taxes reduce the economic well-being of all Canadians."

Finally, probably the bestl-researched study on the damage CGT does to economies was done by the Joint Economic Committee of the United States Congress which found that "the level of investment in the United States compares unfavorably with that of other countries and with the United States' own history.

“Annual U.S. investment is only half the level it was in the 1960s and 1970s. In addition, net private domestic investment has dropped from an average of 7.4 percent of gross domestic product (GDP) between 1960 and 1980 to an average of only 3.0 percent since 1991.

“This downward trend has serious implications for the economy given the strong relationship between investment and economic growth. The diminishing growth of investment can be partly attributed to high costs of capital. The cost of capital measures the return an investment must yield before a firm or an individual is willing to undertake the investment. High capital gains tax rates lower the return on investment, thus increasing the cost of capital and depressing overall investment in the economy.

“Conversely, a capital gains tax reduction would lower the cost of capital and stimulate investment. The effects of increased capital formation would reverberate throughout the economy in the form of higher wages, rising living standards, job creation, and economic growth.

“Furthermore, the U.S. capital gains tax rate exceeds that of any industrialized nation except that of the United Kingdom and Australia (however, even these countries index gains for inflation, whereas the United States does not). Because the United States must compete internationally for capital, high capital gains tax rates place the United States at a disadvantage relative to its competitors. Some of the United States' major competitors, such as Germany and Hong Kong, exempt long-term gains from taxation altogether; and other countries, such as Japan, tax capital gains very lightly. As a result, these countries typically experience higher saving, investment, and productivity growth rates than the United States.

In the December issue of Prospects I suggested that President Ramaphosa could initiate a significant economic upliftment for the country if he were to announce the end of Capital Gains Taxation. Clearly it is an urgent need worldwide!

The Extraordinary Power of the Political Arena

By John Mauldin

"To be absolutely certain about something, one must know everything or nothing about it."

—Henry Kissinger, former US Secretary of State

This month I’ve discussed some possible pathways for 2019. But beyond that, for the past year or so, I have been talking about what I think may unfold over the next decade. The term I often use is The Great Reset, but in my mind it’s more than just resetting global debt.

I think a number of equally important trends, all extraordinarily eventful, some amazingly positive and some frustratingly negative, when taken all together (which we'll have to, like it or not) will produce an era unlike anything previously seen in human history. I call it the Age of Transformation.

We can point back in history to events similar to each of the individual trends. We can even argue some of them happened relatively simultaneously… key word "relatively." The pace of this transformation will be breathtaking. For all of these changes to happen in roughly a decade will be unprecedented.

This is going to be an extraordinarily (and I use that word precisely) difficult period for those relying on historical precedent in their investment planning. You often see the phrase, "Past Performance Is Not Indicative of Future Results," and we need to re-examine what that means. Normally, we use it to say that the past returns of a particular investment may not resemble future returns. It's become part of the legal jargon, usually ignored.

I think we need to parse this further. We should be saying that the circumstances which produced the past performance may not be duplicated in the future. In other words, ***This Time May Be Different.***

I have been pounding the drums for some time to say those circumstances are *not only not going to be repeated in the next decade**, they're going to be profoundly and deeply different.*** Which means we are going to get different results than most people expect.

I want to be very clear here. I'm not being doom-and-gloom. When I say we will get different returns than history suggests, I mean we will need to ***look at the world differently*** to get the results we want. Investment "business as usual" is not going to cut it. Good and maybe even solid returns will be possible, but not with the old paradigms.

I believe we will enter recession within the next two years. Ray Dalio says we will be in a recession in 2020. Mark Yusko argues the US will be in recession by the end of 2019. Mark and Ray are smarter than I am. My crystal ball is a little bit cloudier as to exact timing.

In any case, it makes little difference to our portfolios whether recession strikes in 2019 or 2020. The benchmarks will drop between 40 and 50%—some more, some less. To the extent that you are exposed to stocks and other financial markets, your portfolio is going to take a hit.

The Extraordinary Power of the Political Arena

For a long time, politics have had a short-term significance to the market, but the long-term driving factor was a growing semi-free, semi-capitalistic economy. Further, for almost 40 years the Federal Reserve, beginning with Volcker, provided an era of extraordinarily low rates and easy money. It let governments and businesses worldwide grow their debts alarmingly fast. As I've demonstrated in other letters, global debt could easily reach $500 trillion in a few years. Investors and businesses act like that is normal and can continue.

At some point, we will have a recession exacerbated by extraordinarily high corporate debt. Just like subprime mortgage debt triggered the last recession, corporate debt will trigger the next one. (I am sure there will be congressional hearings and global angst, and new rules will be instituted to limit future ***corporate*** debt, at the same time ignoring and indeed increasing government debt. Sigh.)

This corporate debt will precipitate a liquidity crisis and create havoc in all sorts of "unrelated" markets. Investors will learn, once again, that all asset classes are globally correlated in a crisis. There will be few places to hide.

But then the recession will end, as all recessions do, and recovery begin, because that is what happens after recessions. Except it will be different this time.

Recovery from the Great Recession was the slowest on record. The next recovery will be even slower. I have written about that, citing Lacy Hunt and others. *Debt that is not self-funding* is future consumption brought forward. We are currently enjoying consumption and growth that cannot happen in the future. Debt, then, is a drag on future growth, and the amount of debt the world now has will be a monster drag on future growth. (Note the distinction between debt for current consumption and debt for future production. There is an enormous difference.)

Recessions always bring higher unemployment, on top of technology-driven job losses. This will exacerbate the current political tensions. Humans want scapegoats. Many will blame markets and capitalism, when we have neither free markets or true capitalism. The progressive left's siren song—guaranteed basic income, free college, free everything, etc.—will begin to play everywhere.

If you haven't already heard of the economically illiterate insanity called Modern Monetary Theory or MMT, you will. It says we don't need to worry about government debt; we should simply monetize it. Create and spend whatever we need for the common good. They produce fancy equations and rationales, but monetization is the bottom line. It essentially what Alexandria Ocasio-Cortez and others in her world espouse. They talk about raising taxes on the rich, but there's simply not enough money to do what they propose, even if you take everything the rich have. The arithmetic doesn't add up. So they will have to increase the debt and eventually monetize it. Which is exactly what Japan has done, and seemingly succeeded.

It is that experiment that we in the US are eventually going to try. Past performance is not indicative of future results. With a vengeance. Except that we know exactly what happened in other countries that tried this. Our experiment will yield a new witches brew of problems and opportunities, which we can't yet predict. Buy and hold investing will be perilous. Active management is once again going to be paramount.

US government debt will easily reach $30 trillion within three years after the next recession. Once we begin that next economic experiment, there will relatively shortly be another recession, markets will have an even greater distress situation, and the debt will quickly expand to $40 trillion. Pensions and government deficits will be completely upside down. And then the real fun will begin: quantitative easing on a scale that makes the Bernanke years look like an elementary school picnic. We will simply have no choice.

Now, the world will not come to an end. Markets and (most, though not all) businesses will figure out how to survive. New businesses will keep launching. New technologies will thrive. We will continue to need food, shelter, transportation, communication, and all the things we think of as normal. We will all need medical attention but the potential for living longer, perhaps far longer, will bring investment opportunities everywhere. The challenge will be finding them and getting access. In short, economic activity will still be going on.

This will all happen while technology "eats" jobs faster than it creates them. It was all well and good when we went from 80% of the workforce on farms to 1% today, but that happened over several generations and centuries. We are going to see that kind of upheaval in many industries in half a generation. Can you say frustrated workers? People wishing that they can have their jobs protected? Wanting the government to do something?

I think the political arena will become more important to markets in the coming decade than it has ever been. That is not to say we can't figure it out. But if you are looking at past historical performance to guide your portfolio, you are unlikely to be happy with the outcome.

We are getting ready to enter an era unlike anything in our own experience or in our history books. Analogies? Surely. History, and economic and political history, will be ever more important.

George Box (a British statistician) was the first to say that, "All models are wrong, but some are useful." Let me adapt that to say that all models based on history are wrong, but some are useful. And those based on a proper reading of history will be very useful indeed. (Hat tip for the quote at the beginning and this one: Seth Klarman, see below.)

We Live in Interesting Times

It is said that a Chinese curse is, "May you live in interesting times." For better or worse, we live in interesting times. For most of us it won't be violent, which is what usually accompanied historical interesting times, so for that we can be grateful. But it will be emotionally wrenching.

Seth Klarman, of Baupost Group in Boston, one of the world's greatest value investors (right up there with Warren Buffett) writes an annual letter. I've always found it must-reading when I can get my hands on it. Klarman's latest letter is beginning to make the rounds, and it is certainly circulating in Davos, as it takes a more dire and political tone than his normal musings. He certainly illustrates my point that we live in interesting times. (If someone can get me an introduction to Seth so that I can arrange a meeting, I would be extraordinarily grateful.)

I am going to finish with some selected quotes from Klarman's letter, leaving out some of the more incendiary remarks, even though they are no less true. I've posted the full 21-page letter for ***Over My Shoulder*** members. You need to read it. Here's Seth.

"Social frictions remain a challenge for democracies around the world, and we wonder when investors might take more notice of this. The recent "yellow vest" marches in France, which subsequently spread to Belgium, Holland, and Canada, began as a petition against fuel tax hikes, and grew through social media into a mass protest movement led by suburban commuters, small business owners, and truck drivers. The demonstrations, which appear to have broken out spontaneously throughout the country, became widespread and even violent. While the French government is clearly concerned—in December, it reversed the planned tax increases while announcing a higher minimum wage—the financial markets have taken the unrest largely in stride, as the French 10-year note at year-end yielded a meager 70 basis points...

Social and economic advancement in America today seems increasingly dependent on demography and geography. The economic advantages enjoyed by college graduates continues to grow. Unsurprisingly, income

growth in most major metropolitan areas surpasses gains in rural areas of the country. Economic inequality continued to worsen in 2018, and for many, real wages have not increased in decades. It seems clear that economic anxiety contributed to the election of Donald Trump in 2016.

The divide between Americans has been exacerbated by the echo chambers of modern-day media and the internet. Many have written of how, in only about four decades, an America of three broadcast networks has become an America of hundreds of cable channels. A few decades ago, we had less connectivity but more connection. David Brooks and others write regularly about the challenges of increased loneliness and isolation. A person today can have a thousand Facebook friends—and few, if any, actual friends."

....Amid all this turmoil, should investors simply hunker down and keep their focus on markets? That might be a challenge. By way of illustration, on December 18, on the FedEx earnings call, CEO Frederick Smith noted that "most of the issues that we're dealing with today are induced by bad political choices, I mean, making a bad decision about a new tax, creating a tremendously difficult situation with Brexit, the immigration crisis in Germany, the mercantilism and state-owned enterprise initiatives in China, the tariffs that the United States put in unilaterally. So you just go down the list, and they're all things that have created macroeconomic slowdowns."

These days, Americans do not seem to agree on much of anything. Some of it is today's politics: "Deep state" or dedicated civil servants? "Witch hunt" or legitimate investigation into crimes? "Fake news" or free press? "Alternative facts" or facts? Accomplished adversary or "lock her up?" And some of it goes beyond politics into the realms of scientific inquiry and American values. Climate change or "climate hoax?" Refugees seeking sanctuary or "caravan of foreign invaders?"

Does this matter? We think it does. It's hard for our leaders to guide us when we don't agree on our values or even on how we decide what is true. Worse, our enemies, including but not limited to Russia's autocratic government, are using social media and internet postings to confuse us and divide us further. They know which hot buttons to push. Moreover, our willful disbelief of facts, truth, and science increases the chance that we will fail to recognize or take seriously growing threats. In 1993, Senator Daniel Patrick Moynihan, who famously said that "everyone is entitled to his own opinion, but not to his own facts," observed that America was "defining deviancy down." His point was that behavior that had once been seen as deviant was now considered acceptable. To paraphrase Moynihan, today we may instead be defining reality down.

This post-truth moment is quite dangerous. Imagine an incident that threatens national security. Will Americans see eye-to-eye on the seriousness of the threat? If our leaders are truth-challenged, will Americans believe the official explanation of the threat and the wisdom of the proposed response? Should they?

…We would argue vehemently that democracy, and the liberties and protections it provides, is not just of importance to individual citizens, but also to businesses and markets. In a democracy, businesses have the benefit of equal treatment under the law, including unbiased regulation.

We would also argue that social cohesion is essential for those who have capital to invest. Businesses need a long-term horizon to plan, and social unrest makes planning more difficult. It can't be business as usual amidst constant protests, riots, shutdowns, and escalating social tensions. It is not hard to imagine worsening social unrest among a generation that is falling behind economically and feels betrayed by a massive national debt that was incurred without any obvious benefit to them. If things get bad enough, we could see taxes once again raised to confiscatory levels. We should all be rooting for (and acting to support) social cohesion and a renewal of the American dream.

John here again. George Soros this week said that we are in a cold war with China that threatens to turn into a hot war. While Soros and I agree on little politically, I did find my head nodding at times in his latest CNBC interview. Then Luke Gromen of Forest for the Trees wrote about change in the geopolitical climate, which is not his usual beat. I have become a fan of his writing. Saying US national security may be more important than risk asset performance for the first time in decades, Gromen foresees (quoting his summary):

1. ***<u>Potential rule change</u>: US national security may be more important than risk asset performance for the 1st time in 35+ years (but risk assets don't seem to realize this yet).***

2. ***If we are moving back to a "Cold War" world where US policy is driven more by the national security establishment than the Wall Street/Treasury establishment (as has been the case for the past 30+ years), then it would seem the odds are good that the chart on the front page of the attached pdf would mean revert, implying as much as a 30–60% drop in corporate profits as a % of GDP just to return to the levels that prevailed during the last Cold War, before cheap Chinese labor & (at least temporarily disappearing) Fed largesse elevated US corporate profitability to all-time high %s of GDP.***

3. ***If a new Cold War is indeed breaking out, it would in turn seem to have severe implications for the global & US corporate debt & equity markets—it is HIGHLY unlikely that any of this money was borrowed assuming a 30–60% drop in US corporate profits as a % of GDP was even remotely possible, & on many metrics (IG, HY, leveraged loans, US equities v. ROW), valuations are quite stretched already. There are record levels of leverage in the US corporate debt market, & the rules appear to be changing for national security reasons in a manner quite unfriendly to corporate margins!***

I am in Washington DC for a personal meeting with Andrew Marshall, whom I mentioned two weeks ago. On that occasion, he had to go to the emergency room. Forgivable since he is 97 years old. But he was up and his usual vigorous self today. There were also two US defense strategy mavens in the room. The topic turned to China.

It soon became troubling, at least to me. Andy noted that he had been warning the US government about China's real intentions since the 1980s. (Again, he was appointed by Nixon to run the Defense Department's futurist think tank. He retired three years ago at 94. Every president reappointed him. He is the most significant figure in US geopolitical strategy that you have never heard of, because he never wanted anyone to know who he was. Chinese leaders read everything he wrote. His pictures are on their walls, literally. I can't stress enough how important and influential he is.)

I asked about some of the China analysis I've seen. These experts confirmed everything that I had read and then doubled down. The geopolitical risks are serious. We in the West simply don't understand the Chinese mindset or their intentions, even though they write strategic papers every other year detailing exactly what they are thinking and doing. There should be no surprises. But we ignore these writings as political noise and then try to exploit the vast (and real) potential of Chinese markets, yet it may not work out the way we hope. I will have to write on this in a later letter.

But the point is that we do indeed live in interesting times. We simply can't expect the old investment paradigms to meet the challenges of the future. Past performance is indeed not indicative of future results.

Bull in the China Shop

By John Mauldin

This letter focuses on China's economy. We'll look at some numbers showing the challenges China faces, but they don't explain something important. The way China will meet those challenges is going to be substantially different than we would see in the West. So I want to start with a little context.

When European Central Bank President Mario Draghi promised to solve the financial crisis with "whatever it takes," central bank policy was his only tool. Xi Jinping has a vastly larger toolbox. It is hard for us in the Western world to understand that. Xi not only has every tool a top-down government can have, he has experts to wield them, all of whom are 100% aligned with his goals.

I used the "Bull in a China Shop" pun for this letter's title to create an image in your mind. A bull tears up the proverbial china shop because it can't comprehend the porcelain is expensive, easily broken, and hard to repair. It perceives the shelves as threats to its own freedom and so tries to escape, destroying them in the process. But that won't unlock the door, so the bull stays stuck.

Similarly, many in the West misunderstand China and react counterproductively, breaking things and still not solving the problem.

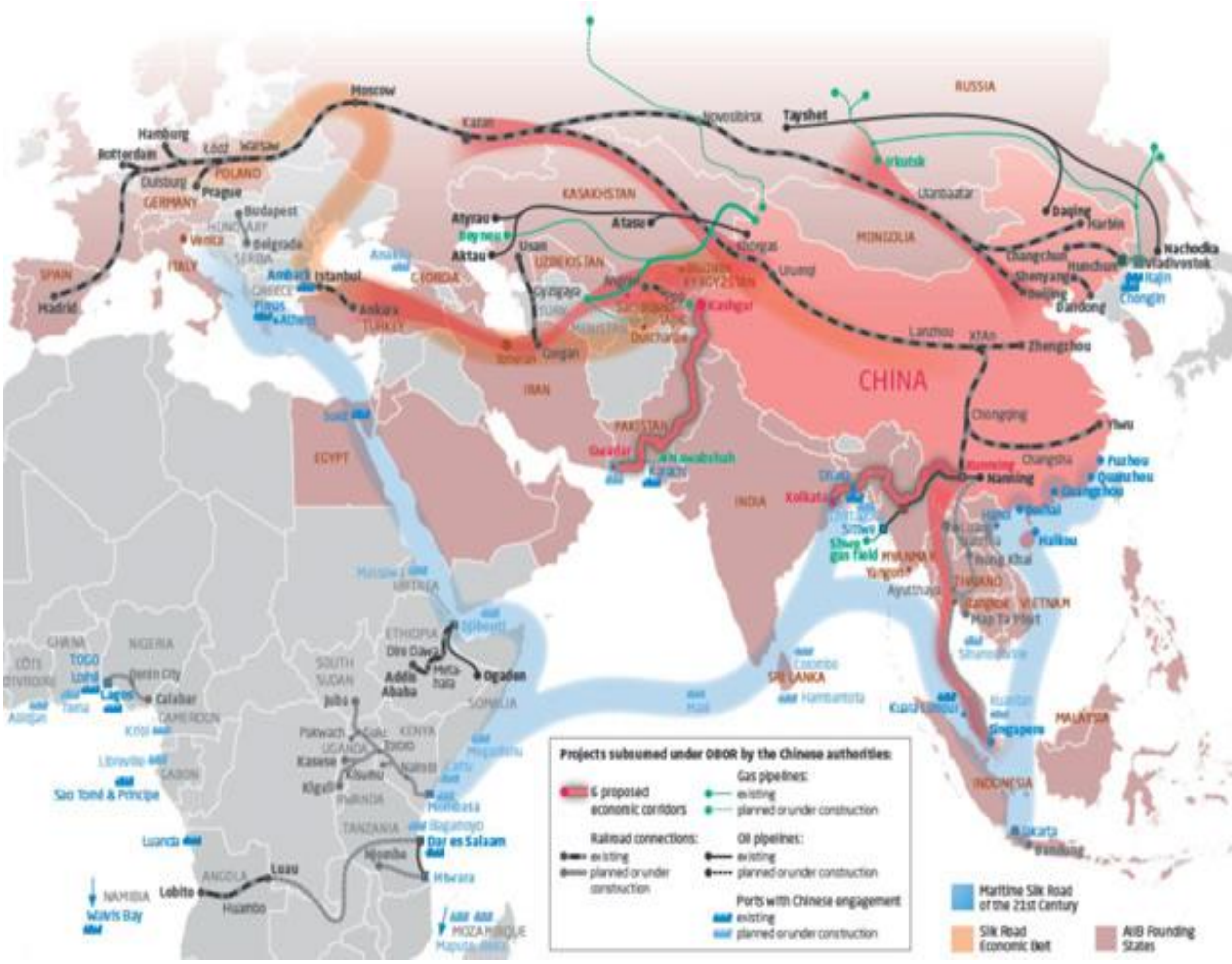
The Stalin, Mao, and Xi quotes above have a common theme. "… engineers of the human soul." Mao venerated Stalin, and Stalin's books sold massively in China. Now

Xi Jinping frequently quotes or alludes to Mao and Stalin. “Socialism with Chinese characteristics” has been the case since Deng Xiaoping.

I spent a few hours with Mark Yusko here in Puerto Rico this week. Mark is a good friend and every time I hear him talk about the opportunities he has found in China, it makes me want to get my checkbook and fly to Shanghai or Guangdong. The country has enormous investment opportunities, and an atmosphere where entrepreneurs can create almost anything they envision.

However, you must realize this comes with a level of government intrusion unfathomable to us in the West. In the US, we’re debating the data collected by corporations like Facebook and Google. Their Chinese equivalents are encouraged to collect such data and share it with the government. Moreover, in every interview that I have heard, the overwhelming majority of Chinese simply don’t care, at least not publicly.

These same Chinese companies will extend their practices along the One Belt, One Road initiative, and where do you think that data will end up? By the way, OBOR is a brilliant strategy from the Chinese point of view.



Source: Gavekal

Xi Jinping is intent on having China once again recognized as an equal global superpower and, at some point, even the leader. The Chinese leadership are all students of Chinese history. They know where they came from, and want to regain what they consider their proper place. They are playing a long game—decades long.

China is investing at least as much in artificial intelligence, robotics and Big Data as the West is, much of it controlled, directly or indirectly, by the Chinese military. So when US and European military planners get, let's just say, ***nervous*** about China's growing capabilities, it is not without reason.

China fully intends for the Yuan to be a global reserve currency. One requirement for that status is willingness to run trade deficits. It is no accident China's large trade surpluses are beginning to dwindle. That is a feature, not a bug. It is by design.

As for intellectual property and patent rights, the Chinese are rapidly creating their own. China graduated 4.5 million, not counting software developers, mathematicians and other scientists. The vast majority of artificial intelligence patents filed last year were Chinese. Their interest in protecting that property is replacing the former practice of stealing the IP shirt off your back.

But China faces numerous challenges, too. Simon Hunt, who has been going to China for 25+ years and knows the country better than any non-Chinese person I've ever met, put it this way.

> ***What should be clearly understood is that China's economy is facing multiple changes in its structure. They include:***
>
> ***- Exporting companies relocating overseas because of rising domestic costs and American tactics (which won't reduce the total imports, just the origination of those imports!)***
>
> ***- A shrinking labour force.***
>
> ***- A focus on high-tech***
>
> ***- The need to build infrastructure to accommodate the migration of another 150 million from the countryside to the urban community*** [in addition to the almost 300 million that have already moved in the last 40 years, in the largest single migration in human history]
>
> ***- The need to focus development on the lower-tiered cities and rural villages***
>
> ***- Whilst continuing the process of deleveraging the economy.***

I talk often about how big China is and how fast it is growing. Often I mention it is the world's second-largest economy after the US. I may have to modify that practice soon.

Standard Chartered Bank said this month China will likely become the world's biggest economy at some point in 2020, using nominal GDP and purchasing power parity. Gentle reader, 2020 is ***next year***. This isn't the far future.

Now, this won't be the end of the world. It is simply math. GDP growth is a function of the number of workers and their productivity. China has more workers (as in four times more) who are getting more productive. At some point, their large numbers outweigh the higher productivity we have in the US and Europe. This is inevitable.

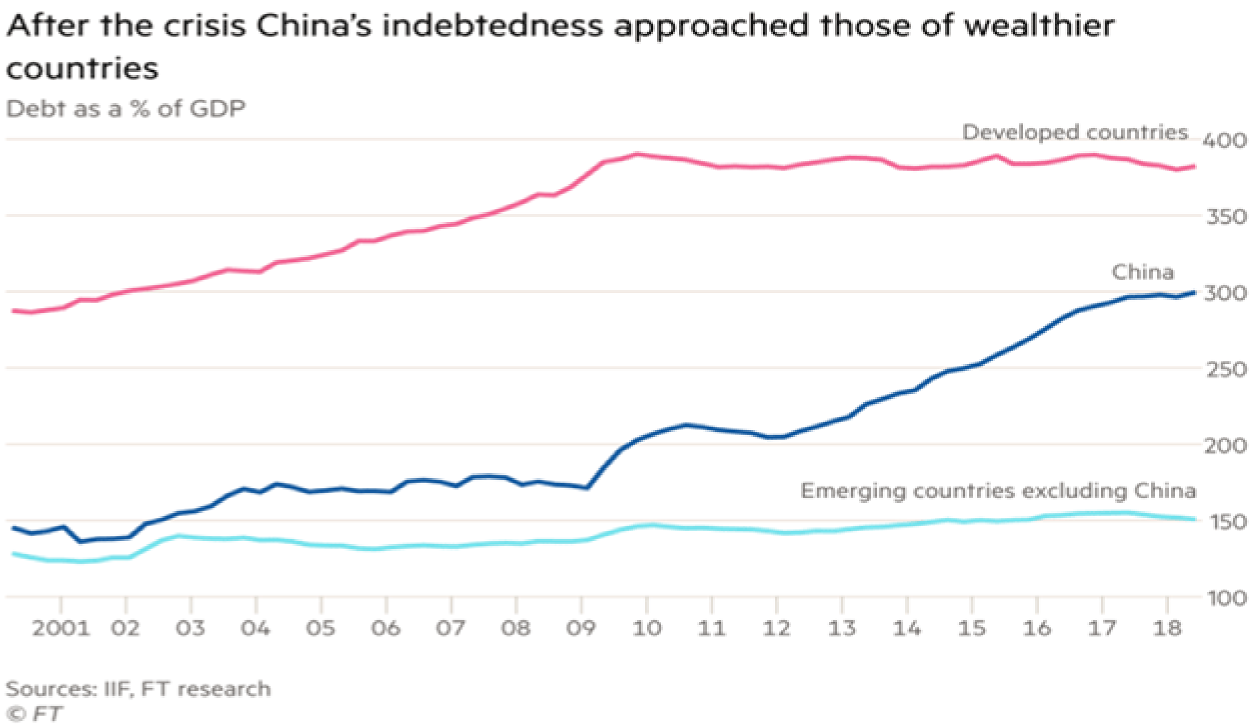
And that rise won't happen without some hiccups. The US and Chinese economies are co-dependent in ways we can't change quickly. Problems in either country ***will*** hurt the other, and both currently have problems.

Demand Pulled Forward

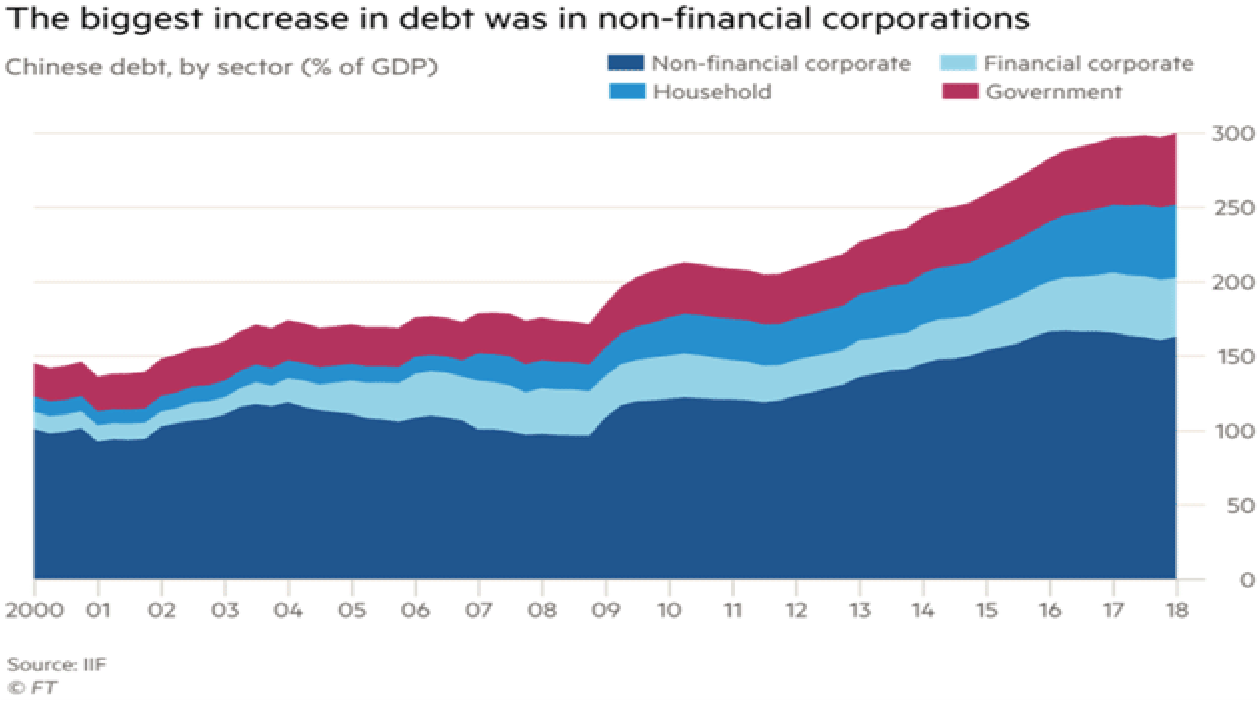
The 2008 financial crisis and recession hit China hard, as it did everyone else. Not every country responded like China did, though. Most couldn't do what China did because they lacked either the financial resources or the political ability. China had both, and so launched a stimulus program of mind-boggling proportions. Beijing compelled local governments and state-owned enterprises to take on massive debt for giant infrastructure projects, huge capacity expansions, and pretty much anything else they could imagine that would put people to work and bolster public confidence. Yes, they built ghost cities.

(Incidentally, the classic ghost city was in Mongolia, literally vacant for a time but now well on its way to being fully occupied or bought. Long game and deep pockets, indeed.)

Not coincidentally, China has doubled its debt relative to GDP since the beginning of the century, and the bulk of that was after 2009.



But it's ***how*** they grew that debt I find amazing. We must remember that the Chinese economy is managed from the top down. The Chinese government is very aware of how its shadow banking system operates. Half of the total debt is from the nonfinancial (i.e., shadow banks) sector. And while Simon Hunt talks about deleveraging, when I talked with him what he really means is that the Chinese government is trying to move from Wild West shadow banking to more traditional bank financing. Central bankers sometimes accompany private bankers to meet loan-seeking businesses. Chinese characteristics, indeed.



In my research for this letter I came across several mentions that China is planning to move another 150 million rural citizens to urban areas, many into so-called second-tier cities. Only in China can a second-tier city have five million people. And people moving from the country into the city becomes far more productive in terms of GDP. And China is beginning to focus on upgrading the infrastructure and the rural cities as well.

As the entire world will come to realize in the middle of the next decade, the debt which financed that infrastructure does have a carrying cost. Even in a top-down economy. Yes, much of it is internal but our first concern is China's enormous amount of dollar-denominated debt. Here's Christopher Balding with the numbers:

> *According to official data, short-term debt accounted for 62 percent of the total [of almost $2 trillion in debt] as of September, meaning that $1.2 trillion will have to be rolled over this year. Just as worrying is the speed of increase: Total external debt has increased 14 percent in the past year and 35 percent since the beginning of 2017.*
>
> *External debt is no longer a trivial slice of China's foreign-exchange reserves, which stood at just over $3 trillion at the end of November, little changed from two years earlier. Short-term foreign debt increased to 39 percent of reserves in September, from 26 percent in March 2016.*
>
> *The true picture may be more precarious. China's external debt was estimated between $3 trillion and $3.5 trillion by Daiwa Capital Markets in an August report. In other words, total foreign liabilities could be understated by as much as $1.5 trillion after accounting for borrowing in financial centres such as Hong Kong, New York, and the Caribbean islands that isn't included in the official tally.*

So, China could owe non-Chinese lenders as much as $3.5 ***trillion***, much of it in USD which are more expensive to acquire than they used to be. This is why a trade war is so threatening to China. Revenue from exports to the US helps pay that debt.

So that's one problem, but the internal debt is not exactly benign. Yes, a state-dominated economy like China's can deal with debt in its own currency. It has many ways to extend and pretend. But they have limits and don't work forever. It has to be worked off.

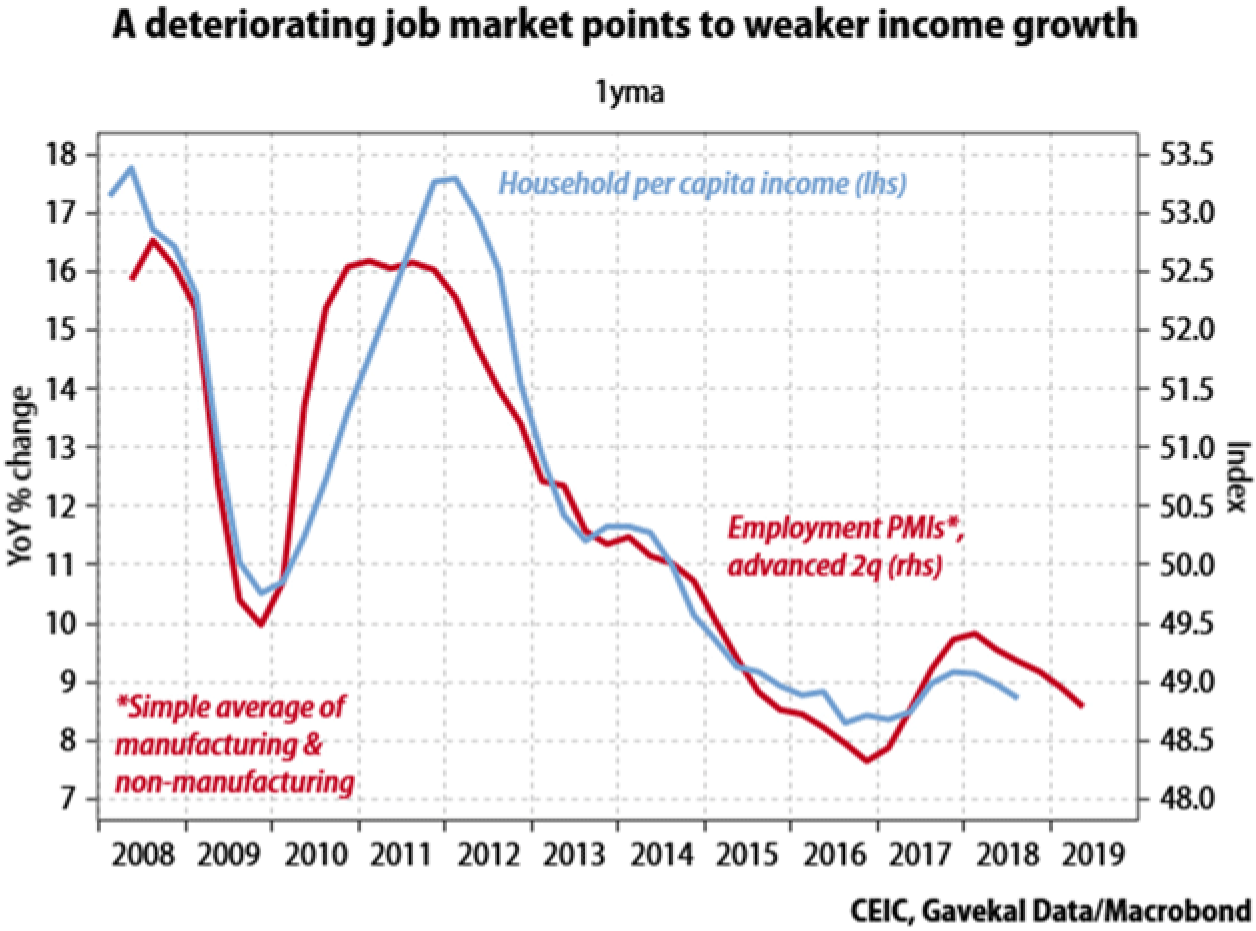
Job Jitters

Leverage is fun. It lets you do things you otherwise couldn't. Deleveraging is the opposite of fun because you must do things you would rather avoid. This is a particular problem for the Chinese government, which must keep a large population fed, housed, and otherwise content. Thus the drive to improve the conditions or move 150 million people from the poverty of rural China to the cities.

Beijing has many tricks up its sleeve but China's labor market has its own dynamic.

From my friends at Gavekal Dragonomics, written by Ernan Cui:

> ***China's job market is proving to be an early casualty of the US-China trade conflict. Layoffs in manufacturing accelerated over the second half of 2018 as US tariffs fell into place, and job losses have now matched the pace seen during the economic slowdown of 2015-6. But the situation is arguably worse this time, as the service-sector employers that previously absorbed many laid-off workers are now being squeezed by tighter regulations. Government officials are trying to adjust and soften policies to help employment, but the outlook for household income and consumer spending in China in 2019 is clearly worsening.***
>
> ***Consumer spending had already slowed in 2018, but most of the deterioration came from a decline in auto sales.*** [Which still total 27 million cars sold.] ***That was largely the result of the end of several years of favorable policies that had front-loaded vehicle purchases; spending on services and other consumer goods actually held up fairly well. But China looks to be headed for a more broad-based slowdown in consumer spending in at least the first half of 2019. The employment components of the PMI surveys, both for manufacturing and non-manufacturing sectors, started to deteriorate sharply in September. These are decent leading indicators of household income growth (see chart), so a further slowdown in income and consumption in the next couple of quarters is almost guaranteed.***



Now, we should note that Chinese economic data is questionable in the best of circumstances. The last thing Beijing wants is to give the public rigorous data proving how hopeless its job-hunting is, or how unlikely its income is to grow. Fortunately, we have alternative sources like Gavekal, China Beige Book, and others with on-the-ground presence and access to non-government data.

Gavekal in their broad-based research found an amazing data point, too. The graph below shows an index of Chinese internet searches for the word “layoff.” Notice where it is now compared to 2008 and other recent economic slowdowns.

Now, this doesn't mean Chinese employers are actually conducting layoffs. It means people are looking for information on the topic, and I think it's fair to call that a sign of worry. What is causing this concern? Do Chinese workers see something that bullish Western analysts are missing?

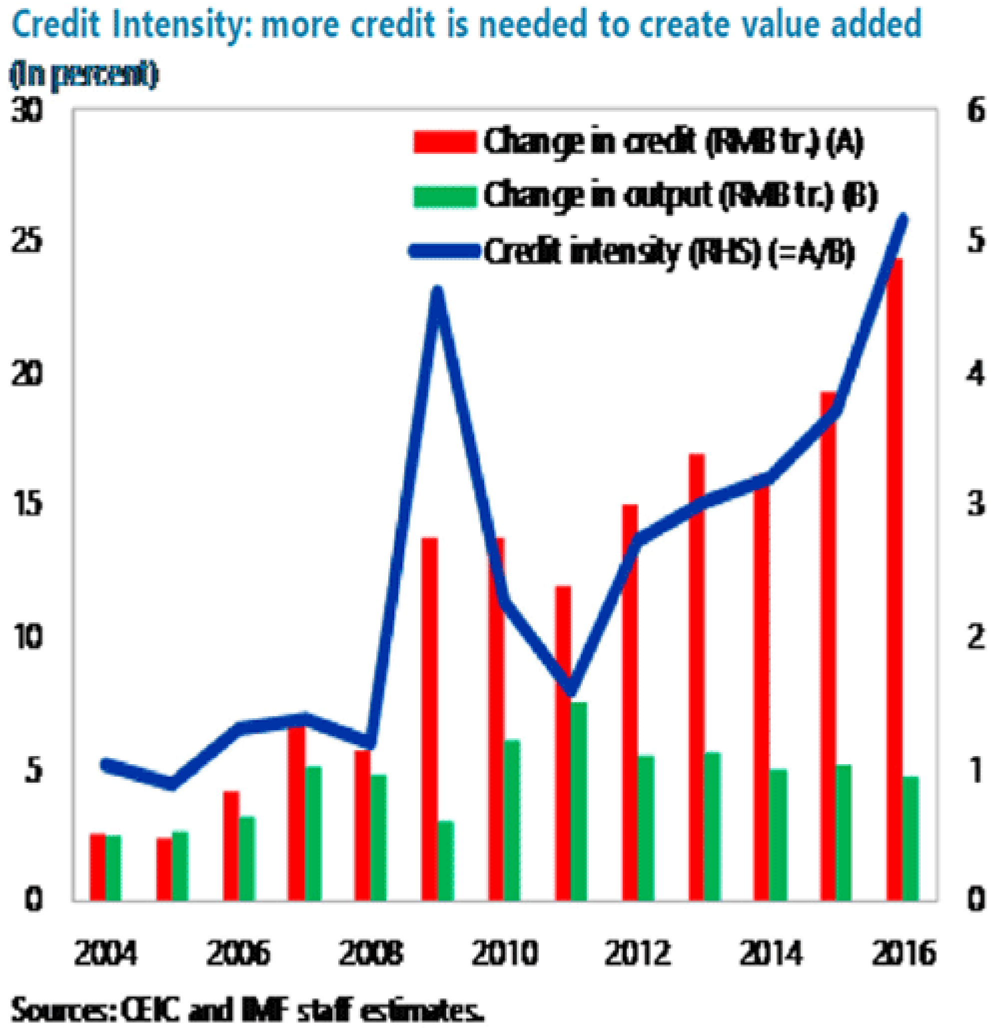
Credit Intensity

Economic weakness is relative. Like anything else, coming down from a level to which you are accustomed is hard, even if you land in a place that isn't so bad in absolute terms.

Assuming (for discussion's sake) the official numbers are right, China's GDP growth has been around 4% ***at worst*** going all the way back to the 1980s, and usually much higher. The US has struggled to achieve anything near that. So a decline from the 6.9% growth seen in 2017 to, say, 6%, is a big deal to the Chinese. And that's what the government apparently expects. Reuters reported on January 11 that in March the government will announce a 2019 growth target goal in the 6-6.5% range… and China always hits the target. Funny how that works.

Here in the US we would celebrate 4% growth. (I think by the end of 2019 we may be wishing for even 2% growth.) In China, they will hit the proverbial panic button at anything south of 6%. Look for the government to respond with even more debt and infrastructure spending to try and stimulate the economy and maintain growth in the 6% range.

The problem is, like a medicine to which the body adapts, debt is no longer having the same kind of effect. An IMF study last year measured China's "credit intensity" over time.



Source: IMF

I'm sorry that picture is fuzzy—it's that way in the original, too. Here is how they explain it. I bolded the important part.

> ***However, over the last five years, domestic nominal credit to the nonfinancial sector has more than doubled, and the domestic nonfinancial sector credit-to-GDP ratio rose to about 235 percent of GDP as of end-2016.*** [2] ***During this period, the efficiency of credit expansion has increasingly deteriorated, pointing to growing resource misallocation.*** *In 2007-08, about RMB 6½ trillion of new credit was needed to raise nominal GDP by about RMB 5 trillion per year. In 2015-16, it took more than RMB 20 trillion in new credit for the same nominal GDP growth.*

So in less than a decade, the amount of debt needed to produce a given impact on GDP more than ***tripled***. I've cited data from Lacy Hunt showing a similar trend in the US but it's nowhere near that magnitude.

That tells us something important: In the next downturn, slowdown, or whatever you call it, Beijing may not be able to borrow its way out of the hole. Or if it does, the amounts could be astronomically high.

But absent debt stimulus, what else can they do? As noted, Xi Jinping has many tools. Some are more pleasant than others. I seriously doubt he has any way to restore growth to what everyone wants without massive adjustments (i.e., more debt). And it will be painful not just for Chinese, but Americans, too.

Rushing the Process

That being the case, now is not the best time for a trade war between the US and China. Yet we find ourselves in one. Let me again give my requisite disclaimer, since I always get letters saying, essentially, “China bad! Must do something!”

Yes, China hasn’t played fairly in a number of ways. I get that. We have issues and problems that need resolution. Prior efforts haven’t worked. I get that, too. We have national security concerns about China, totally apart from our trade disputes. Granted on all counts.

It does **not** therefore follow that slapping tariffs on Chinese imports is the right answer. We have to fix these things, but without shooting our own feet. American and Chinese businesses have spent the last two decades integrating supply chains and developing markets with each other. Every one of us benefits from that integration every single day.

Could we reverse the integration and become less interdependent? Yes, of course. It’s happening already, simply due to technology that is letting production move closer to consumers. That’s a natural process that will continue. Rushing that process, while probably possible, would have a cost.

Last week I mentioned the US microchip companies that in some cases get half their sales from China. Some are one tariff away from being out of business. Gone, kaput. Stock zero, all employees jobless, all their small-business suppliers, bondholders, and bank lenders left to fight over the scraps in bankruptcy court.

This is one of my greatest short-term fears: that the Trump administration’s hardline tactics will push China into recession, which for them is less than 4% growth. The president himself seems to relish the prospect. He’s talked proudly of the way Chinese markets fell due to his policies. Maybe he thinks the threats will make Xi back down. I don’t think they will. We are pursuing a high-risk policy that will have ***massively*** negative consequences if it fails.

I titled this letter “Bull in the China Shop” because that is what we need to avoid. Running around breaking things may be satisfying in the moment, but the cleanup isn’t fun at all.

An extraordinary level of savings

by Brian Kantor

Chief Economist and Strategist, Investec Wealth and Investment

If you could borrow as much as might wish at close to zero rates of interest for ten or more years you would surely do so. There would be no lack of projects that promised wealth generating returns of at least one per cent p.a.

Of course such funding opportunities are not readily available to any ordinary business or household. Lenders would demand a premium to cover risks of default and would raise the prospective returns potential investors would have to achieve.

But such considerations do not apply to the German, Japanese, Netherlands or even the Brexit stressed UK government or the Swiss that can borrow at negative rates of interest. Lenders pay for the privilege of funding the Swiss government – for ten years and more. These governments can borrow as much as they might wish at very low rates.

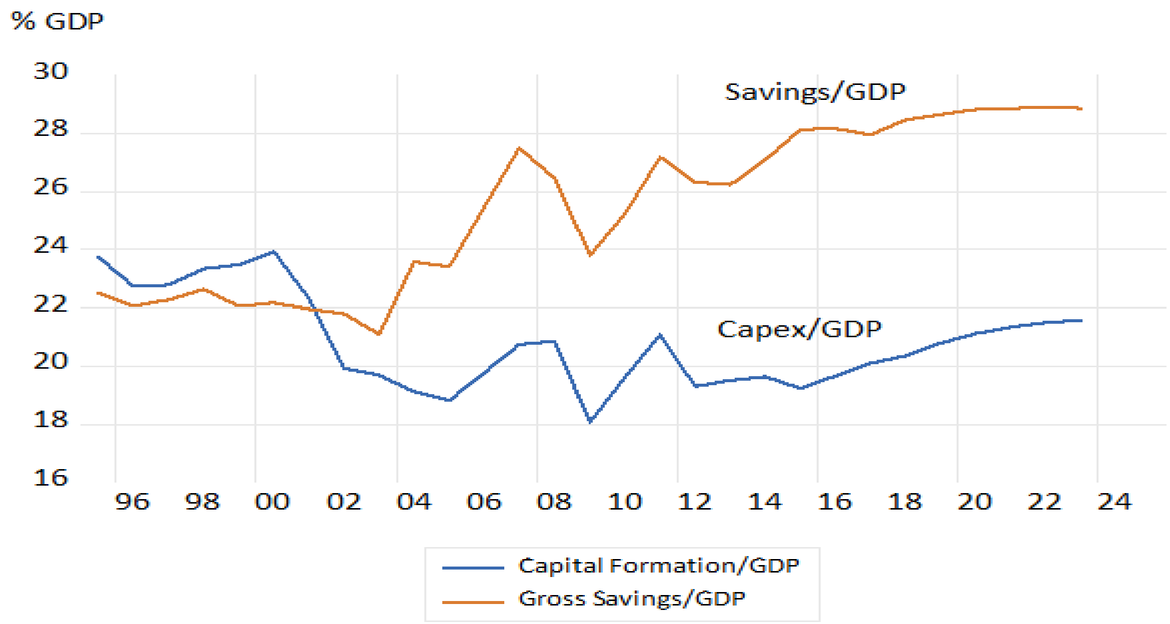
Surely an extra bridge or highway, port or pipeline or even a dyke helping to create a productive polder can promise a one per cent per annum return? Governments with such favourable credit ratings neither have to undertake the construction nor the management of such low return projects that can be leased to private operators- who win competitive tenders to do so. And if governments would exercise such opportunities to borrow more at invitingly low rates – also, heaven forbid, to cut income and expenditure tax rates – aggregate demand for goods and services would be stimulated. And businesses would add to their productive capacities, including their work forces. And depressed rates of growth of GDP and accompanying incomes would accelerate.

Demands for credit especially bank credit would be encouraged, bank balance sheets would strengthen, while the national savings rates would decline and interest rates could rise for very good reasons. Because demands for capital to invest would be rising rise faster than supplies of savings.

The failure to respond to respond sensibly to an extraordinary level of savings and the accompanying low interest rates is the essential European economic problem. The rate at which the Germans have saved has increased dramatically since 2000, while the rate at which they have added to their stock of capital fell away.

Germans in 1995 saved about 22% of their incomes- a very high rate for a developed economy. They are now saving 28% of their very large GDP that is forecast to rise further. They add to their capital stock at a 20 per cent of GDP rate. This has meant dramatically larger flows of capital out of Germany into global capital markets. In 2018 outflows of about 400 billion dollars were estimated.

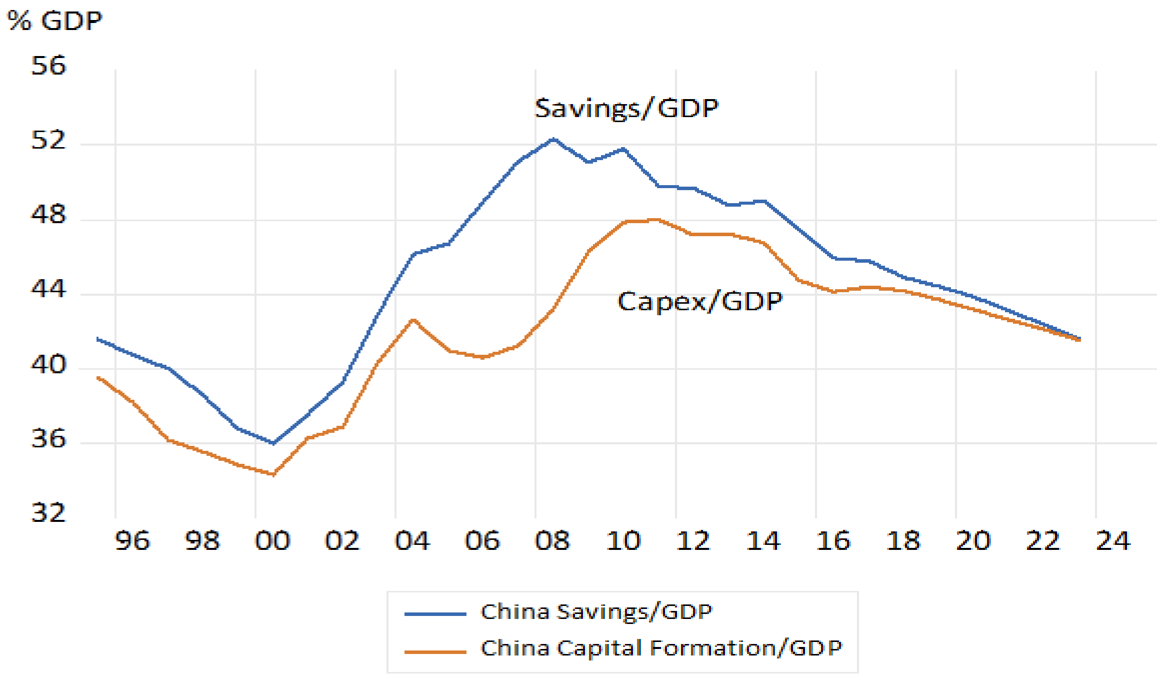
Savings and Capital Formation ratios to GDP in Germany. Annual data



Source; IMF World Economic Outlook 2018 and Investec Wealth and Investment

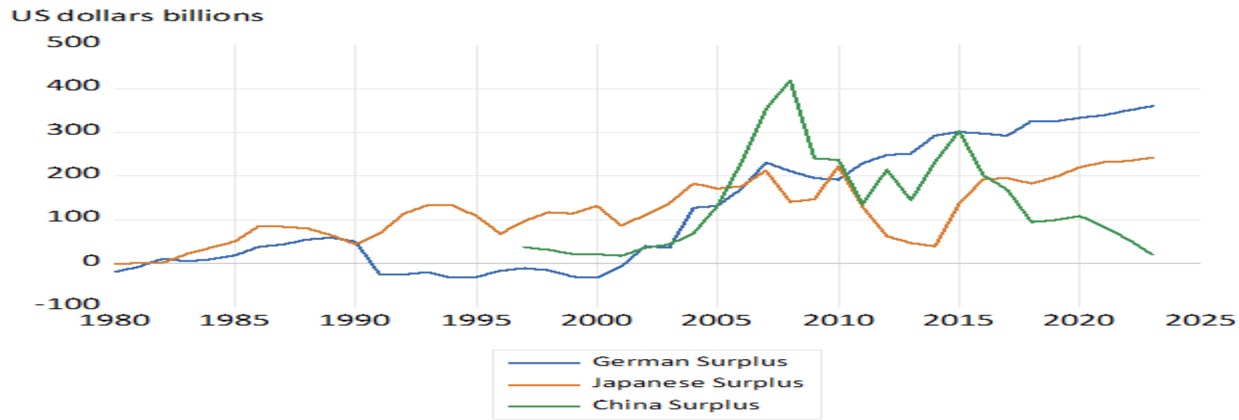
The Dutch are now saving a similarly high proportion of their incomes and the Japanese are a further major source of global savings. The Chinese save at an even higher rate, over 40% of GDP, though the rate at which savings are made and capital formed has been falling. China is no longer a significant contributor to the global savings pool. A fact that may well inhibit its ability to stimulate its economy.

China – saving and capital formation to GDP ratios. Annual data



Source; IMF World Economic Outlook 2018 and Investec Wealth and Investment

Contribution to global capital markets. The combined surpluses of Germany, Japan and China (US dollar billions)

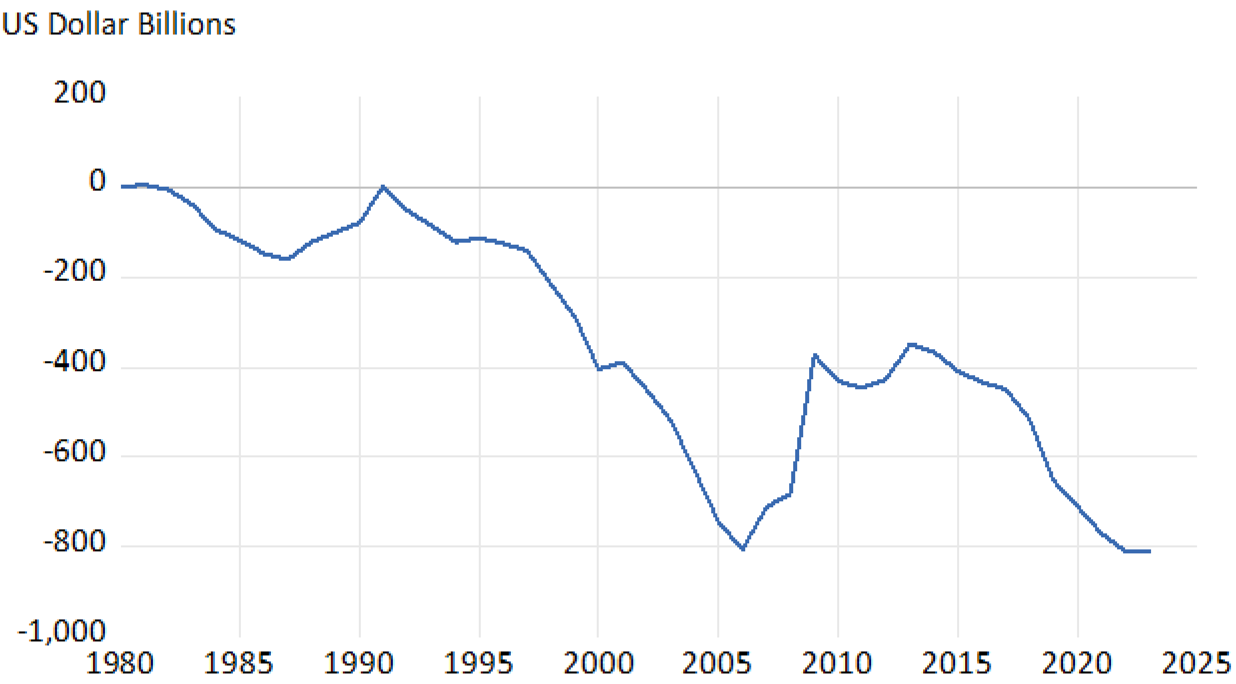


Source; IMF World Economic Outlook 2018 and Investec Wealth and Investment

The contribution in 2007 to the global savings pool from China, Germany and Japan amounted to nearly a trillion US dollars – compared to about a mere $100b seven years before. It is now about $600b.

The borrowers to absorb these surpluses at low interest rates were naturally found in the credit hungry US. Inflows of capital to the US expanded dramatically after 1995 – much of it funding houses that had to be abandoned by their owners after 2008. The average US home lost 30% of its pre-global financial crisis value. No mortgage based financial system could hope to survive a collapse in asset values of this magnitude- without a bail out.

US capital inflows 1980- 2023 – A tale of growing dependence.



Source; IMF World Economic Outlook 2018 and Investec Wealth and Investment

Less not more austerity is urgently called for in northern Europe- to help save the euro and the European project. The Italian and other populists are on the right track while the German fiscal conservatives perversely continue down a dead end.

Investing? Don't follow the herd

By Patrick Duggan

Wealth Manager, Investec Wealth & Investment

Investing may have changed over the years, but the propensity of humans to follow the herd seems as strong as ever.

I was conducting an interview with a prospective employee a few months ago and, in order to see where his thinking was at, I decided to ask him how he might invest a hypothetical R1m. He responded by saying that he would place a significant amount of these monies in a well-known leading JSE-listed share.

Now I'm not passing judgement on this particular share as a security selection – there are far more qualified people than myself to do so – but what intrigued me was why he'd selected this specific security. On pressing him for his reasoning he struggled to articulate his thinking and my conclusion was that he may have succumbed to herd mentality, aka the fear of missing out (FOMO).

Think back to a moment when you were younger, a teenager perhaps, and there was something you wanted to do because it was suddenly cool and it seemed like everyone you know—and many people you didn't—were doing it. Just as you're about to dive into whatever the fad of the season is, someone (a parent, teacher, observant adult) stops you and tells you no. "But everybody's doing it!" You whine. "And if everyone jumped off a bridge, would you do it too?" If this exchange is familiar to you, then you already know something about herd mentality.

People have a tendency to mimic or emulate the actions of other people in a large group. Unfortunately for all of us, we don't always choose to imitate the rational behaviours of others. Sometimes, herd mentality stems from copying the actions of people of high status, but often, herd behaviour is the result of going with the crowd.

Herd mentality in markets

We see lots of examples of herd mentality in investing and financial decisions, due in no small part to the fact that many people don't really understand what they are doing when it comes to the markets. Let's start with a classic example of herd mentality: the tulip mania.

In the late 16th century, the Dutch tulip market was booming. Tulips were a novelty for most of the world and were one of Holland's major exports. They were so popular that men were making and losing fortunes in one night. In fact, tulips were selling at as much as 10 times the price of the work from skilled craftsmen. The price of tulips skyrocketed thanks to trading in tulip futures. When the bubble (widely considered to be the first such financial bubble) finally burst in 1637, fortunes were lost. Why would people go crazy for tulips? The simple answer is herd mentality.

From our perspective almost 400 years later, trading on tulip futures seems ridiculous. Why would anyone do that? However, we should not throw stones. Two modern bubbles were almost as ridiculous: the Dotcom bubble at the tail end of the 20th century and the subprime mortgage crisis of 2008. Critics of the cryptocurrency boom of recent years suggest that a similar phenomenon may be taking place in that space.

Modern investment decisions can be fueled as much by emotion as logic, perhaps more so. We observe our peers funneling cash into apparently sound investments—investments that are sure to go up and make us rich! When that happens, most people follow suit. Few individuals take the time and effort to do the research, but rather are swept up in the rising tide of enthusiasm and hype.

In a **[Twitter thread from author Jim O'Shaughnessy]** in July, he offered, among other things, these sage observations on the predictability of human nature.

Jim O'Shaughnessy
@jposhaughnessy

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1/ I believe that the highest probability bet you can make in your investment strategy is that human nature will remain a constant for the foreseeable future. For my book "Predicting the Markets of Tomorrow", I analyzed nearly 200 years of data

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Jim O'Shaughnessy @jposhaughnessy · Jul 26
2/and found that the rolling 20-year real rate of return to financial markets ebbs and flows with a remarkable degree of consistency. I believe this is so primarily because human beings are responsible for the economic and stock market cycles.

3 20 99

Jim O'Shaughnessy @jposhaughnessy · Jul 26
3/While the types of companies and industries that get us excited has and will continue to change over time, our reactions to them will remain the same—we'll get unusually excited about the new and over-price it and be blasé about the old and under-price it.

2 22 122

Jim O'Shaughnessy @jposhaughnessy · Jul 26
4/Be it steamboats, railroads, telegraph and telephones, automobiles, motion pictures, radio, TV, aluminum, "space-age" technology, the first computer makers, internet stocks, nanotechnology or quantum computers, our human reactions to innovation are sure to persist.

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Jim O'Shaughnessy @jposhaughnessy · Jul 26
5/Just as in the past, we will more than likely drive their valuations to unsustainable levels. Our basic human nature is probably more responsible for the long-term ebbs and flows in the market than any single economic event or innovation.

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How to avoid the herd mentality and make better investment decisions

As ever, when it comes to investing, you have to do the research and follow the path of logic and facts, not the way of media hype and enthusiasm from all quarters. If you can learn to use the conscious part of your brain for investment decisions, you can pick up stocks that others might be overlooking— and sell before the next bubble pops.

If indeed you cannot give enough time to doing the research yourself then you should consult with your financial adviser.